IFRS Accounting in Progress
from a student perspective

Edited by
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Preface

Students in the course International Accounting at the master level are encouraged to partake not just in class discussions but also in giving classes. This partaking pedagogical orientation helps the students develop analytical and integrative capabilities for dealing with international financial reporting and international accounting policy issues. As a result of this pedagogical direction the students have written, from a student perspective, a text book on different aspects on IFRS accounting.

Without financial support from KPMG this book project would probably not have been finalized. However, for all remaining mistakes and errors the authors are solely responsible.

Linköping, 2013

Stefan Schiller and Simon Lundh
List of Abbreviations

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<tr>
<td>AADB</td>
<td>Accountancy and Actuarial Discipline Board</td>
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<td>ACCA</td>
<td>Association of Chartered Certified Accountants</td>
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<td>APB</td>
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<td>CACPA</td>
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<td>CCAB</td>
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<td>Committee of European Securities Regulators</td>
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<td>Conceptual Framework</td>
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<td>CFA</td>
<td>Chartered Financial Analyst</td>
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<td>CGU</td>
<td>Cash-generating unit</td>
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<td>CICPA</td>
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<td>CIMA</td>
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<td>CIPFA</td>
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<td>CSRC</td>
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<td>DCF</td>
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<td>European Financial Reporting Advisory Group</td>
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<td>FDI</td>
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<td>Generally Accepted Accounting Principles</td>
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<td>Global Investment Performance Standards</td>
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<td>HKICPA</td>
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<td>IAASB</td>
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<td>ICAEW</td>
<td>Institute of Chartered Accountants in England and Wales</td>
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<td>The Institute der Wirtschaftsprüfer</td>
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<td>IFAC</td>
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<td>International Financial Reporting Standards</td>
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<td>IMCP</td>
<td>Instituto Mexicano de Contadores Publicos</td>
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<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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ISA  International Auditing Standards
JICPA  Japanese Institute of Certified Public Accountants
LTO  Long-Term versus Short-Term Orientation
MAS  Masculinity versus Femininity
MIPA  Mexican Institute of Public Accountants
MoF  Ministry of Finance
MoU  Memorandum of Understanding
NAFTA  North American Free Trade Agreement
PAT  Positive Accounting Theory
PDI  Power Distance
PRC  People’s Republic of China
RFR  Swedish Financial Reporting Board
SEC  Security Exchange Commission
SIC  Standing Interpretations Committee
SME  Small and medium-sized entities
SPE  Special Purpose Entity
UAI  Uncertainty Avoidance
US GAAP  United States Generally Accepted Accounting Principles
WP  Wirtschaftsprüfer
WPK  Wirtschaftsprüferkammer
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We live in a time of financial turmoil that bodes extensive structural changes. The financial crisis led, through several channels, to a sharp fall in private spending (Krugman, January 6, 2013). The financial crisis is worsened by underlying structural imperfections such as an uneven distribution of competitiveness between countries and regions, and, in some countries, the profits have surged as a share of national income, while wages and other labor compensation are down. In addition, territorial disputes, for example, in the South China Sea but also in the East China Sea, are a potential threat not just to the immediate region, but to the entire world. Hence, we live in an era that faces huge problems and great opportunities. And this holds for accounting as well.

The title of this textbook is *IFRS Accounting in Progress – from a student perspective*. Master students present their articulated views and understanding of IASB as an accounting rule-maker and of the current accounting standards in progress, given the particulars of the present time. First, this editorial will dwell on some of the observations made about student-centered learning (SCL) during a masters-level course in advanced accounting. SCL is an approach to teaching that focuses on the needs of students rather than those of lecturers and educational administrators. Thereafter, the editorial will briefly reflect on the urgent need for new theories within the field of accounting. Thence, heuristics or experience-based techniques for making accounting judgments and learning will be discussed. Finally, the structure and the different chapters of this textbook will be presented in brief.

In the literature there are different definitions of SCL, partly because they take different perspectives such as a cognitive view or a social constructivist view, or they take a more practical orientation (O’Neill and McMahon, 2005). The present textbook takes a broad view of SCL, which is considered to include aspects of choice, of doing, and of power. Lecturer-centered learning (LCL) and SCL are seen as the two ends of a continuum, using these aspects of choice, doing and power: low level of student choice versus high level of student choice, passive student versus active student, and power resting primarily with the lecturer versus power resting primarily with the student. It is important to point out, however, that the lecturer has the sole responsibility for defining and upholding the academic requirements of the curriculum. Furthermore, it is important to realize that the two orientations do not exclude each other, but are instead complementary. Lea et al. (2003, p. 322) summarize some of the literature on SCL, including the following aspects, which are also in line with this textbook’s view:

1. A reliance on active rather than passive learning,
2. An emphasis on deep learning and understanding,
3. Increased responsibility and accountability on the part of the student,
4. An increased sense of autonomy in the learner
5. An interdependence between lecturer and learner,
6. Mutual respect within the learner-teacher relationship,
7. A reflexive approach to the teaching and learning process on the part of both lecturer and learner.

Basically, SCL aims to stimulate deep approaches to learning. Regarding this emphasis on deep learning and understanding, empirical observations (Baeten et al., 2010, p. 243) indicate that if lecturers are involved and oriented towards students and changing their conceptions, students are apt to use a deep approach. Moreover, Baeten et al. (ibid., p. 243) indicate that students who are satisfied with the course quality (e.g. appropriateness of workload/assessment, lecturing, and clarity of goals) employ a deep approach. Further, students whose personality is characterized by openness to experience, extraversion, conscientiousness, agreeableness and emotional stability tend to use a deeper approach (ibid., p. 243). And, if students are intrinsically motivated, feel self-confident and self-efficacious and prefer teaching methods that support learning and understanding, a deep approach will be more frequently adopted (ibid., p. 243). In an interesting doctoral thesis, Rosander (2012) finds that personality traits are important to academic performance in general, but sometimes more specifically to different school subjects. The major conclusion is that the personality traits of conscientiousness, extraversion and neuroticism correlate with overall academic performance. Initially, she believed that the personality trait of openness, being synonymous with intellectual curiosity and creativity, will lead to high ratings. Thus, if she is correct that deep learning occurs best among those who belong to the open personality type, then, given the terms of competition in the global market, SCL is an important approach to learning. By extension, the educational system has to adjust in order to better accommodate intellectually curious and creative students. Accordingly, it can be predicted that those countries that best succeed in adjusting their educational system will gain the upper hand in the global competitive environment.

The textbook’s chapters are a point in case, demonstrating a deep approach to learning; and, at the same time, they are also indicative of the efficiency of the SCL approach to learning.

A recurring observation at the class level is that different classes within the same major over the years are not as homogeneous as one might expect. Instead, they differ as to how they perceive themselves as a class. Moreover, the general trend, which is quite clear is that, the learning outcomes significantly improve over the years. Interestingly, students seem to learn in a natural way from other or more experienced students. This may, in part, relate to the observation that the more capable students are, the better the study materials they produce. Motivation is probably one key to the learning impact from producing study materials for fellow students. Further, IT is an important and a unifying platform for SCL in that communication is a key factor in this approach to learning. This implies that the SCL environment is facilitated by or presumes advanced IT support. And, from a lecturer perspective, when the students get to choose, they tend to choose current topics; which places great demands on the lecturer’s ability to relate to and absorb knowledge within that particular field of discussion. Given these observations, it is probably fair to claim that SCL is an advanced form of learning. However, obviously,
some students find it easier to apply the SCL approach to learning than others, which is something the educator constantly has to be aware of.

As to the issue of an alleged need for new theories within the field of accounting, Danielsson (1983) emphasized the importance of putting studies at firm level, or group level, in relation to studies focusing on a more aggregated level. Danielsson concedes, however, that studies of relationships between levels of analysis are inherently difficult to pursue from a methodology point of view. The economic approach to accounting theory puts an emphasis on controlling the behavior of macroeconomic indicators that result from the adoption of different accounting techniques (Riahi-Belkaoui, 2004). The general criteria used in the economic approach to accounting theory are that accounting principles and accounting techniques should reflect “economic reality” (Brooks, 1976) and that the choice of accounting techniques should depend on “economic consequences” (Zeff, 1978). Riahi-Belkaoui (2004, pp.115-116) stresses that “the economic approach and the concepts of “economic consequences” and “economic reality” have been revived since the creation of the Financial Accounting Standards Board (FASB).” And, consequentially, the International Accounting Standards Board (IASB) maintains that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making economic decisions about providing resources to the entity (Conceptual Framework, (CF)). The use of this information will result in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole (CF, QC37). Thus, the economic approach is given a pivotal role in both the FASB and the IASB.

The economic approach to the formulation of an accounting theory has influenced various accounting theories. This approach to accounting, however, is not a recent phenomenon; Coase (1990) made a call as early as the 1930s for interdisciplinary studies between economics and accounting. It is not surprising, then, that basic economic assumptions have found their way into accounting. For example, positive accounting theory is based on the suggestion that managers, shareholders, and regulators are rational and that they attempt to maximize their utility (Riahi-Belkaoui, 2004). This kind of assumption facilitates the formulation of rational models, but these come at the price of relevance and usefulness.

These rational models can be contrasted with behavioral finance models, which highlight inefficiencies such as under- or over-reactions to information as causes of market trends; and in extreme cases of bubbles and crashes (cf. Barberis et al., 1998; Daniel et al., 1998). However, it is difficult to get alternative viewpoints to break through in science. Sometimes, it is even difficult to do research outside the dominant paradigm. The economics editor at BBC News, Stephanie Flanders, makes the observation that “the central economic debates we hear now over how best to handle the aftermath of a financial crisis are not much different from when Hayek and Keynes did battle more than 80 years ago.” The financial crisis has dislodged the economies of nations and regions into new, and unfamiliar, territories for which we do not have adequate theories. The key cause of the financial crisis is a lack of open debate and discussion. A number of independent “thinkers” have taken up the gauntlet, among them Nobel Prize laureates Paul Krugman and Joseph Stiglitz. The Institute for New Economic Thinking (INET) is an independent think tank founded in 2009 with the aim of supporting academic research and teaching in economics outside the dominant paradigms of efficient markets and rational expectations. INET has on its advisory board, besides Joseph Stiglitz, Nobel
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Prize laureates George Akerlof, Sir James Mirrlees, A. Michael Spence, James Heckman, and Amartya Sen. Obviously, given the linkage between economics and accounting, we need a similar think tank within the field of accounting.

As noted by Paul Krugman (December 9, 2012), the American economy is still, by most measures, deeply depressed; at the same time, corporate profits are at a record high. Krugman offers two plausible explanations: one is that technology has taken a turn that places labor at a disadvantage; the other is that there is a sharp increase in monopoly power. In the book, “Race Against the Machine,” Erik Brynjolfsson and Andrew McAfee discuss how information technologies are affecting jobs, skills, wages, and the economy. And, in particular, how information technologies are accelerating innovation, driving productivity, and transforming employment, and the economy; what is new is that many of the jobs that have been made obsolete by information technologies are high-skill and high-wage. Brynjolfsson and McAfee (2011) identify three alternative explanations to why productivity growth has slowed and why the median income of American families has stopped rising as quickly as in the past. First, the cyclical argument holds that there is nothing new or mystical going on. Unemployment is high because the economy is not growing fast enough to put people back to work due to inadequate demand. Second, the stagnation argument maintains that the pace of technological innovation has slowed down, which affects, among other things, America’s ability to increase productivity. A variation of the stagnation argument is that other nations, particularly those located in the Asian region, have begun to catch up, and, in some areas, even surpassed Western economies. Third, the end-of-work argument holds that accelerating information technologies are putting millions of people out of jobs, jobs that will not return. Probably, these arguments are not mutually exclusive, and can be regarded as complementary.

A fourth argument, the third industrial revolution, which also relates to the previously mentioned arguments, focuses on reindustrialization. This argument holds that there is an urgent need to bring outsourced industry back to Europe, as advocated by Antonio Tajani, European Commissioner responsible for Industry and Entrepreneurship (EU, Brussels, October 10, 2012). How has this proposal been received in Germany, which is the leading economy in Europe? It has been met with interest in that the argument has been widely reflected in German newspapers, for example, in Süddeutsche Zeitung, which writes that “Die EU-Kommission schlägt industrie- politischen Alarm: Die Industrieproduktion in der EU liege 10% unter dem Vorkrisenniveau, über 3 Mio. Arbeitsplätze seien verloren gegangen und der Anteil der Industrie am Bruttoinlandprodukt (BIP) sei auf zuletzt 15,6% (2011) gesunken ... Dieser Trend müsse umgekehrt werden, um nachhaltiges Wachstum und hochwertige Arbeitsplätze zu schaffen. Die «dritte industrielle Revolution» könne die Industrie zurück nach Europa bringen” (Munich, Thursday October 11, 2012, Süddeutsche Zeitung).

The issue of reindustrialization has also been brought up in the USA. Krugman (December 9, 2012) observes, for example, that “one of the reasons some high-technology manufacturing has lately been moving back to the United States is that these days the most valuable piece of a computer, the motherboard, is basically made by robots, so cheap Asian labor is no longer a reason to produce them abroad.” Stiglitz (January 19, 2013), however, alleges that “globalization and technological advances have led to the loss of good manufacturing jobs, which are not likely ever to come back.”

The question arises how feasible, in general, it is to bring home outsourced businesses, together with transferred knowledge. There are several indications that there will be many hindrances to be overcome, if this is possible at all. Anyhow, the often-cited
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post-industrialized society has yet to materialize; which brings us to the constant need to improve our understanding of real-world phenomena.

There is a general perception that principles-based accounting is more likely to result in transactions that reflect their true economic substance than is rules-based accounting. IFRS are considered to be principles-based standards in that they establish broad rules as well as dictating specific treatments. Accounting principles are general decision rules derived from both the objectives and concepts of accounting, which provide a conceptual basis for accountants to follow instead of a list of detailed rules. Principles-based standards rely on accounting judgments, and disclosure of the choices made and the rationale for these choices are essential from an accountability as well as a valuation perspective. This section of the editorial, which is based on a paper written by the editor (Schiller, 2013), addresses the issue of how to get a grip on how accountants go about tackling complex accounting problems when they are given principles-based discretion.

Today, there is general acceptance that knowledge, skills and intangibles have become the key drivers of competitive advantage in business firms (c.f., Teece, 2000). What distinguishes intangible assets is that they are unique, at least in some sense, and must be assessed individually. This makes accounting of intangibles an interesting issue from a judgmental perspective. Moreover, the value of intangible assets arises in a specific context, which means that in some situations it may be difficult to distinguish one intangible asset from another tangible or intangible asset. Generally, intangible assets only generate cash flows in combination with complementary assets (RedU 7). Tangible fixed assets, working capital, technology, the workforce, brands and established customer relationships are examples of contributory assets (ibid.). Complementary assets in the view of IFRS 3 (2008) are more or less related to marketing-related intangible assets such as trademarks, trade names, service marks, collective marks and certification marks. IFRS 3 (2008) further explicates that brand and brand name typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulae, recipes and technological expertise.

Furthermore, IFRS 3 emphasizes that the standard does not preclude an entity from recognizing, as a single asset separately from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives. Teece (1987), who was the first to define the concept of complementary assets, has a more comprehensive, inclusive definition. Teece differentiates between complementary assets which are generic, specialized, and cospecialized: Generic assets are general purpose assets which do not need to be tailored to the innovation in question; Specialized assets are those where there is unilateral dependence between the innovation and the complementary asset; Cospecialized assets are those for which there is a bilateral dependence (ibid., p. 289). In most cases, successful commercialization or use of an innovation can only be accomplished in conjunction with other generic, specialized or cospecialized assets and capabilities.

In addition, intangible assets are distinctly linked either to a business model or business process more generally, or to an innovation process more specifically. An innovation consists of certain knowledge (often technical knowledge) about how to do things better than the existing solution or design (c.f., Teece, 1987). If the know-how in question can be codified, then the know-how meets the contractual-legal criterion as well as the separability criterion and can be recognized as separate from goodwill (IAS 38.12). Usually intangibles are so specific that there is no active market for them or comparable transactions (IAS 38). In a business combination, the identification of intangible assets
not previously recognized requires a vigilant and thorough analysis of the acquired company’s business model, value drivers, business plans, and business legal environment (RedU 7.16). Upton (2001, pp. 69–70) identifies important differences among internally generated intangible resources in that some, like R&D and software, are created in quite a similar way as tangible assets, while others, like customer lists, brand names, and databases, often come from the operating activities of a reporting entity. Still others, for example, value of insurance-in-force, exist only due to their relation to some other asset or liability. It is, according to Upton (2001), mainly items in the second and third groups that present substantial challenges in identification, recognition, and measurement. Development projects are intangible in nature; any value assignable to them is based on the underlying know-how rather than to physical items such as prototypes (Alexander et al., 2009, p. 296).

An intangible economic resource arising from development or from an internal project should be recognized if, and only if, the reporting entity can demonstrate six criteria, one of which is the technical feasibility of completing the intangible asset so that it will be available for use or sale (IAS 38.57). The significance of the technical feasibility criterion is underlined by the findings of, for example, Wyatt (2005, p. 967), which indicate that the entity’s choice to record intangible assets is associated with the strength of the technology, the time-to-market, and property-rights-related factors that affect the entity’s ability to capture future economic benefits. Furthermore, results reported by Dedman et al. (2009) suggest that R&D activities are not systematically misunderstood by the market.

The concept of innovation might serve as a basis for the identification, recognition, and measurement of intangible assets by imparting conceptual relevance to the recognition criteria stated in IAS 38.57. The term innovation comes from the Latin, innovare, meaning “to make something new”. Different observers tend to rely on different definitions of innovation. Tidd et al. (2005) offer a definition that captures the essence of the term by assuming that “innovation is a process of turning opportunity into new ideas and putting these into widely used practice” (p. 66). IAS 38.57 identifies when the innovation or development process will turn a new idea into a new product with a future of wide use in practice. According to IAS 38, development costs after the technical and commercial feasibility of the new product for sale or use have been established and before the product is available for general release are capitalized. Hence, IAS 38.57 defines when an innovation becomes an innovation.

By relating IAS 38.57 criteria to a robust model of an enterprise’s innovation process, perceived from a senior management perspective, the reliability of the recognized information may be enhanced, and/or may affect the timing of recognition.

Assets can be perceived as a repository of future economic benefits. As the future is uncertain by definition, accounting for intangible assets includes an element of uncertainty. Hence, accounting for intangible assets requires a certain amount of judgment under uncertainty. Generally, intangible assets can be acquired in a business combination, separately acquired, or internally generated (c.f., IAS 38). Accounting for intangibles in a business combination, and for internally generated intangible assets in particular, requires a great deal of judgment in uncertain circumstances. This has been taken into account by the IASB.

The Accounting Standards Board of Japan (ASBJ; 2008) conducted a survey covering a period of three years of accounting treatment of internally generated development costs of fifty large corporations, and concludes that “if an accounting standard similar to IAS
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38 would be introduced in Japan, it would be necessary to incorporate more specific guidelines with regard to how management should make estimates and judgements” (ibid., p. 4). The ASBJ’s conclusion indicates the need to complement IAS 38 with additional guidelines or heuristics.

People, according to Tversky and Kahneman (1974), tend to rely on a limited number of heuristic principles when dealing with complex and/or uncertain tasks. In most cases, these heuristics are quite useful, but sometimes they lead to systematic errors. Frequently, heuristics are associated with how experienced individuals or experts solve problems or make judgments. Contrasting experts with novices, findings suggest that experts’ knowledge is represented at a deep level, while novices’ knowledge is represented at a more concrete and surface level. In physics, for example, it appears that experts classify according to the major physics principle governing the solution of each problem (Chi et al., 1981). A translation of this finding into the field of accounting would suggest that an experienced accountant may use heuristics to identify what model, or more generally, what accounting principle is applicable to what accounting problem based on experience.

Initially, this identification or pattern-matching process takes place in the intuitive judgment system, or System 1, which is characterized by being fast, parallel, automatic, effortless, associative and slow-learning. The experienced accountant’s mental schemata contain procedural knowledge, which helps in identifying and making use of applicable models. Hence, the deliberate operations of System 2, or reasoning, take the upper hand, checking and putting the model to effective use. The process of System 2 is characterized as being slow, serial, controlled, effortful, rule-governed, and flexible. Eriksson and Mehanovic (2012) conclude that in order to appropriate the gains of a fast technological cycle, large companies tend to build up formal heuristics. This indicates that the size of the company has implications for the extent to which heuristics will be applicable.

The value of intangible assets, which holds for all assets, is directly related to future benefits; the problem of assessing the value of assets is that we can only make educated guesses about the future. Thus it is imperative for the preparer of financial reports to provide all relevant information about material accounting items and events so that the reports meet the common needs of most users, including the need to assess the accounting judgments made concerning identifying, measuring and recognizing internally generated intangible assets. Referring to future benefits calls for accountability, or giving reasons for the judgments made in the financial reports. One important source of accountability information is that disclosed in the notes to the financial statements. According to the FASB (2012) a disclosure in the notes is applicable if the information, individually or in combination with other related information, would affect users’ assessments of prospects for cash flows by a material amount (ibid., p. 47).

Given the importance of intangible assets, including internally generated assets, as a value driver for economic growth, there is good reason to assume that information disclosed in the notes about what accounting judgments are made concerning internally generated intangible assets, and on what grounds, is relevant information. The grounds can include assumptions made, which heuristics of judgment are applied, and which biases are avoided. In addition to meeting the needs of users, by providing this accountability information the preparers will also develop their skills in making accounting judgments regarding internally generated intangible assets. Also, from a regulating point of view, the standard-setters will be able to collect and analyze information that reveals not just accounting practice, but the thinking and reasoning of preparers regarding internally generated intangible assets.
According to Ashton and Ashton (1999), accounting judgment tasks are to be related to institutional professional settings, which include generally accepted accounting principles, a highly structured system. Although heuristics yield “rough and ready” solutions, they draw on underlying processes that are highly sophisticated (Kahneman and Tversky, 1974). From an accounting point of view, it is vital that judgments and intentions produced by System 1 can be modified or overridden by the deliberate operations of System 2, that is, that a direct interrelationship exists between intuition and reasoning. This indicates that heuristics are experience-based, which makes it interesting to study accounting judgments from a heuristics perspective. By studying the underlying processes on which accounting judgments are founded we can learn more about how accountants reason in relation to various accounting standards given different economic situations. The focus is on how accountants go about tackling complex accounting problems. Hence, this paper takes a different view on heuristics and biases related to accounting judgments than do previous research in that the main focus is set on the use and design of heuristics and biases and to a lesser extent on departures from normative decision-making behavior.

The editor of this textbook is well aware of the fact that most students do not have long-standing experience in accounting practice. The proposed method for studying how experienced accountants solve complex accounting problems may, however, be helpful even for non-experienced students of accounting, especially when they are as capable as the authors of this textbook.

The contents of this textbook, *IFRS Accounting in Progress – from a student perspective*, have been organized in five sections. Section 1 “Fair value accounting” consists of one chapter, Section 2 “Convergence of accounting standards and auditor’s work tasks” is made up of two chapters, and Section 3 “Consolidated accounts” comprises two chapters. Section 4 “Selected exposure drafts” includes three chapters; whereas Section 5 “Goodwill” consists of two chapters.

**Section 1 Fair value accounting**

Chapter 1 *Fair Value Measurement – The Complexity of Valuation* is written by Eva-Marie Heldesten, Caroline Lagerholm and Susanna Persson. Summary: This chapter seeks to explain the differences between the definitions of fair value and the content of the different standards, and to answer the question if fair value measurement meets the different criteria for financial reports. The new standard IFRS 13 *Fair Value Measurement* applies to IFRSs that require or permit fair value measurements or disclosures and provides a single IFRS framework for measuring fair value and requires disclosures about fair value measurement. The authors conclude that there are various definitions of fair value, but with the new standard IFRS 13, the definitions harmonize. Furthermore, the views regarding fair value differ and it is obvious that there is no valuation method that is impeccable. Measuring all assets and liabilities at fair value is inappropriate; however, for some assets and liabilities it seems to be the best choice.
Section 2 Convergence of accounting standards and auditor's work tasks

Chapter 2 The challenges of accounting standards convergence process – with focus on IFRS and US GAAP is written by Lina Edqvist, Malin Ekdahl, Madelene Görö and Sarah Pers. Summary: The ultimate goal of accounting standards convergence, as stated by the FASB and IASB, is a single set of high-quality, international accounting standards that companies worldwide can use for both domestic and cross-border financial reporting. Demand for international convergence is driven by investors’ desire for high-quality, internationally comparable financial information that is useful for decision-making in our increasingly global capital market. However, there has been criticism directed towards the convergence process. After reviewing the subject, the authors conclude that the main problem in the convergence process is not factors such as auditing and accounting culture or language, but is instead the combination of the fact that the US is a country with a strong regulatory system, generally known for allowing lawsuits for many different reasons, and that it uses a rules-based accounting approach.

Chapter 3 The role of the certified public accountant in different countries is written by Anna Karlsson, Maria Peiving and Andreas Sandin. Summary: This chapter sets out from the observation that even though the work of a certified public accountant (CPA) has been the subject of harmonization with the help of standards and auditing practices over the years, the auditing is still carried out very differently across the world. After studying the practice of auditors in China, Germany, Japan, Mexico, the UK, and Sweden, the authors come to the conclusion that the culture of a country, how education and knowledge are organized, the form and efficiency of its legal system, and who the main providers of finance to the companies are, all have an impact on how auditors work. The authors conclude by noting that all countries in this chapter are members of IFAC and if everyone were to use one standard, such as ISA, many differences and problems might disappear.

Section 3 Consolidated accounts

Chapter 4 Consolidation of financial statements is written by Hugo Lilja, Andreas Magnusson, Björn Smedman and Martin Tingvall. Summary: This chapter sets out to explain the differences in the definition of control between the old standards IAS 27 Consolidated and Separate Financial Statements and SIC 12 Consolidation—Special Purpose Entities and the new IFRS 10 Consolidated Financial Statements. IFRS 10 outlines the requirements for the preparation and presentation of consolidated financial statements, requiring entities to consolidate the entities they control. Control requires exposure or rights to variable returns and the ability to affect those returns through power over an investee. The authors conclude that the new single control model in IFRS 10 will lead to consistency in the consolidation procedures. All entities will have to follow the same guidelines and, if applied correctly, this will enhance the comparability between companies’ financial reports.

Chapter 5 IFRS 11 Joint Arrangements is written by Moa Ramberg, Martin Rodenberg and Nathalie Thörnqvist. Summary: IFRS 11 Joint Arrangements outlines the accounting by entities that jointly control an arrangement. IFRS 11 uses the form and true content of the arrangement instead of the legal form of the agreement. IFRS 11 has first and
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foremost made it easier to compare different companies that account in accordance with IFRS. One purpose of IFRS 11 was to achieve convergence with the US GAAP, yet this was not reached. However, IFRS 11 reduces the differences between the standards, and it also increases the possibility of comparing companies that account in accordance with the two standards.

Section 4 Selected exposure drafts

Chapter 6 Lessee accounting is written by Emelie Bojmar and Malin Petersson. Summary: The purpose of this chapter is to obtain a greater understanding of the proposed lessee accounting model and how implementing it can change lessee accounting (ED/2010/9). By means of analytical reasoning, the authors evaluate the potential advantages and disadvantages that the Exposure Draft may bring about. The authors conclude that if the problem is considered to be the classification between operational and finance leases, then the IASB’s solution of developing one single accounting model is accurate. On the other hand, if the problem is considered to be that the lessees abuse the explicit criteria in IAS 17, a better solution would be to modify the criteria. And whether the ED/2010/9 provides a less accurate depiction of leasing activities or not depends on whether the lease agreement is considered to be similar to a debt-financed purchase or a rental agreement.

Chapter 7 Hedge accounting – simplified with new rules? is written by Linus Lindholm, Mikael Örtenvik, Björn Forsberg and Alexis Muhoza. Summary: The purpose of this chapter is to provide the reader with an understanding of hedge accounting before and after the change of the hedge accounting requirements that will be added to IFRS 9 Financial Instruments, and to discuss whether a move to a principles-based standard better reflects the risk management activities of companies. By answering the questions: (1) How is the new standard perceived by standard setters, preparers and users of financial statements, and (2) In what manner does IFRS 9 better reflect risk management activities of entities? the authors come to the conclusion that a clearer definition of the hedge effectiveness objective, together with the option to use qualitative tests, will better align accounting with strategy. Furthermore, the removal of the retrospective test should open up hedge accounting to a wider range of companies. Moreover, the authors maintain that the move to a principles-based standard has done much in order to better reflect companies’ risk management activities, but there is still a need to investigate further how to simplify hedge accounting.

Chapter 8 Revenue Recognition – the past, the present and the future is written by Erik Fyhrlund, Emma Hedman, Anna Sjögren and Jenni Strand. Summary: This chapter sets out to describe the reasons behind the convergence project of revenue recognition between the FASB and the IASB. Additionally, the question regarding how the new proposed standard, Revenue from Contracts with Customers, will affect entities and users of financial statements are discussed. The stated objectives of the proposed standard are to remove inconsistencies and weaknesses in existing revenue requirements, improve comparability and provide more useful information to the users of financial statements. Concerning the issue of how Revenue from Contracts with Customers will affect entities and users of financial statements, the authors come to the conclusion that the new standard will facilitate for entities in many ways, i.e. by using the five step model for all
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revenues and by providing more and clearer guidance. This can lead to a better match between revenues and expenses, resulting in a truer and fairer view of the financial statements.

Section 5 Goodwill

Chapter 9 Management’s possibilities to affect impairment of goodwill is written by Sarah Bengtsson, Fridolf Gustavsson and Ann-Sofie Vedenbrant. Summary: A company reporting under IFRS follows the principles in IAS 36 Impairment of Assets. The US GAAP and IFRS contain similar impairment indicators for assessing the impairment of non-current assets. The authors discuss the problem of impairment testing and how management measures whether there is a need for impairment. How significant is measurement? Is there room for management to make free interpretations? After analyzing the subject, the authors conclude that it is possible for management to make their own interpretations, as the various valuation models are based on various factors. IAS 36 gives the management room for discretion. The factors may include discount rate, expected future cash flows and recognition of revenues.

Chapter 10 Essence and complexity of goodwill is written by Julia Färnemyhr, Anna Gustavsson, Lina Hederberg and Johan Norrman. Summary: By definition, goodwill is a complex, abstract, and open-ended item, and, consequently, there are ongoing efforts to reduce the costs and complexity of applying goodwill impairment guidance. The authors raise questions about what goodwill really is and if it is too complex to be informative and relevant to the users. The aim of this chapter is to investigate the essence of goodwill and especially to analyze the usefulness of the information received in financial reports. The questions at issue are: What is the essence of goodwill? Why is goodwill reporting complex? and How important is disclosure to the users of the financial reports? Compared to amortizations, the procedure with impairment creates larger fluctuations in earnings. An inconsistent area in the treatment of impairment is that it is not allowed to reverse impairment. This fact leads the authors to conclude that goodwill is only a residual, and that it might then be better to call goodwill lines of errors and omissions to clarify for the users what it really is.

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Editorial


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Internet


Section 1
Fair value accounting
Chapter 1
Fair Value Measurement – The Complexity of Valuation

Eva-Marie Heldesten
Caroline Lagerholm
Susanna Persson

1.1 Introduction

One of the most important and protracted debates in accounting is what something is worth, i.e. the valuation of assets and liabilities (Marton et. al, 2010). Historical cost, which is based on transactions, is used in the traditional theory of accounting, but accounting can also be value-based, which means that all assets, liabilities, revenues and expenses are measured at fair value (ibid.).

The International Financial Reporting Standards (IFRS) is becoming a global language for accounting and the development started in the 1970’s as a vision to harmonize the different accounting norms in the world (Precht, 2007). When the International Accounting Standards Board (IASB) introduced the IFRS, fair value was presented as the primary basis of measurement. This resulted in a large number of firms’ assets and liabilities stated in their balance sheet at fair value (Lindsell, 2005). The IASB and the Financial Accounting Standards Board (FASB) consider it to be the most relevant measurement basis of today, and its popularity has grown since the IFRS was first introduced (ibid.); however, the opinions on fair value differ.

There are some criteria that the information in the financial reports needs to meet to ensure that the information is usable; these are understandability, relevance, reliability and comparability (Conceptual Framework). There is a challenge in finding a way to value assets and liabilities so that they live up to the criteria.

One problem with fair value is that there have been significant differences between the IASB and the FASB and how they recognize fair value (Marton et. al, 2010). Because of this the IASB and the FASB started to collaborate in 2008 to put together a common standard for fair value (ibid.). The IASB calls this standard the IFRS 13, and it is a new standard that does not change when to apply but how to use fair value. Nothing like this existed when earlier fair value only was mentioned in different standards regarding assets and liabilities (Nordlund, 2012). The same content as in the IFRS 13 can be found in FASB’s Topic 820, an upgrade from the former Financial Accounting Standards (FAS) 157, which is presented in the US Generally Accepted Accounting Principles (GAAP) (IFRS, 2011b). One of the purposes of the IFRS 13 is to give fair value a consistent definition worldwide, and to clarify this, the definition of fair value is now based on exit price (Nordlund, 2012). The IFRS 13 also includes a fair value hierarchy where the
highest priority is given to quote prices in active markets (IFRS, 2011a). The definition, including exit price and the fair value hierarchy, result in a market-based measurement rather than an entity-specific measurement (Deloitte, 2012a).

The Chartered Financial Analyst (CFA) Institute has their own set of standards called Global Investment Performance Standards (GIPS) (GIPS, 2010). The CFA Institute wants the GIPS standards to be “[… an accepted set of best practices for calculating and presenting investment performance that is readily comparable among investment firms, regardless of geographic location”. The GIPS standards imply that fair value should be used at all time (ibid.).

This chapter seeks to explain the differences between the definitions of fair value and the content in the different standards. Further, the question regarding if fair value meets the different criteria for financial reports and the different opinions for and against fair value will be discussed. It will also be discussed if the fair value measurement should be used for all assets and liabilities.

After reading this chapter, the reader should:

• Have basic knowledge of valuation models, and especially fair value measurement;
• Be able to understand the problems related to fair value measurement;
• Be able to explain the different opinions for and against fair value.

1.1.1 Disposition

This chapter begins with key definitions to get an understanding of the basic concepts in the text. Further the Conceptual Framework and valuation models are treated to give an understanding of the importance of valuation. After this, the reader should have the basic knowledge to understand the remaining issues raised. The development of fair value is described as well as different aspects of fair value. Finally, the theoretical and empirical facts are discussed and analyzed followed by a conclusion.

1.2 Definitions

Fair value has been defined differently in different regulations and standards. The US GAAP defines fair value as an exit price while the previous IFRS defined fair value as an entry price (E&Y, 2011). However the new IFRS 13 changed their definition of fair value to define it the same way the US GAAP does (Deloitte, 2012c).

1.2.1 Exit price

The exit price is the price that would be received to sell an asset or paid to transfer a liability (Deloitte, 2012b).

1.2.2 Entry price

The price a particular firm pays at purchase (Deloitte, 2012c).
1.2.3 Definition of historical cost

Historical cost is the price or the purchase price paid for an asset at the time of acquisition (Bokföringstips, 2007a).

1.2.4 Fair value according to the IAS 2

There are several different definitions of fair value in the IFRS. One of the most common definitions; “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”, is found in the International Accounting Standards (IAS) 2.

1.2.5 Fair value according to the FAS 157 and IFRS 13

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.

1.2.6 Fair value according to the GIPS standards

The amount at which an investment could be exchanged in a current arm’s length transaction between willing parties in which the parties each act knowledgeably and prudently.

(GIPS, 2010)

1.3 The Conceptual Framework

The IASB Conceptual Framework of financial reporting states that the purpose of the financial statements is to provide information that is useful when making financial decisions (Conceptual Framework). Because of this purpose it is important that the information in the financial statements is relevant and faithfully represent what it purports to represent, these to things are stated as the fundamental qualitative characteristics of financial reporting. Among these there are other specified characteristics that make the information useful, i.e. understandability, reliability, and comparability (ibid.):

• Relevance: Information is relevant if it affects the financial decisions of users by facilitating the assessment of past, present, and future events or to confirm or correct previous estimates.

• Faithful representation: To be a perfectly faithful representation, information would have three characteristics. It would be complete, neutral and free from error.

• Understandability: Information needs to be easily understandable for users. Users are assumed to have a reasonable knowledge of business, finance and accounting and a willingness to study the information with reasonable diligence.

• Reliability: Information is reliable if it is not biased and does not contain material misstatements. Users must be able to rely on the information being correct.
• Comparability: Users must be able to form a view on trends in the entity’s performance and position by, over a longer period of time, comparing the financial reports provided by the entity. Users must also be able to compare the financial statements of different entities respecting the financial position and performance.

1.4 Valuation methods

Determining what constitutes the value is difficult, close to impossible (Marton et. al, 2010). The best approximation of an ideal value is the present value of future cash flows attributable to a particular asset. The major difficulty with the present value is that the future is largely uncertain, which implies that the amount of future payments is uncertain. The choice of a starting point, deciding between transaction-based accounting (historical cost) and value-based accounting (fair value), gets consequences on how to value the assets and liabilities in the balance sheet (ibid.).

At the time of purchase, the historical cost normally coincides with the market value (Marton et. al, 2010). The market value is the price where the equilibrium between supply and demand arises and at this equilibrium, the individuals’ willingness to pay emerges, which reflects the fair value of an asset. At the time of the transaction, historical cost is used even at a value-based basis. Otherwise, the market value is replaced by the net realizable value or its replacement value. Replacement value is the price that a new asset would command if it were purchased on the measurement date (ibid.).

The IASB Framework indicates that the possible valuations are historical cost, replacement cost, net realizable value and present value of future payments (Marton et. al, 2010.). However, the Framework also indicates that other methods may exist. The Framework defines historical cost as the fair value of what is given up in exchange for the asset, or received in exchange for the debt. For that reason historical cost coincides with fair value at the acquisition date. The difficulties with valuation arise after the date of acquisition, when the historical cost and fair value normally differ from each other (ibid.).

1.4.1 Valuation models

An entity cannot normally choose how to apply the valuation methods, they must follow the rules set out in the accounting laws and accounting standards (Bokföringstips, 2007b). There are three current valuation models in the IFRS for assets and liabilities; historical cost, revaluation and fair value (Marton et. al, 2010). Since historical cost and fair value are the most common valuation models (Marton, 2008), this chapter will only process these two.

The historical cost is the far most fundamental and common model for valuation (Marton et. al, 2010). The basis is that the assets or liabilities are measured at historical cost, and never above this value. However, the impairment loss is recognized if fair value is less than the carrying value (ibid.). In the current IFRS, assets or liabilities can or must be measured at historical cost (Deegan & Unerman, 2011).

Fair value implies that the asset or liability is measured at fair value at the annual account and that no systematic revaluations are made (Marton et. al, 2010). Changes that occur in value after the first annual account can either affect the statement of income or be transferred directly to equity, depending on the asset or liability in question. Fair value
is obligatory for the majority of financial assets, biological assets and certain liabilities, but it is optional for financial assets and liabilities and investment properties (ibid.). The table below shows when entities can or must use a certain valuation method (Marton, 2008).

<table>
<thead>
<tr>
<th>Asset/liability</th>
<th>Obligatory use</th>
<th>Optional use</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical Cost</td>
<td>The majority of assets and liabilities</td>
<td>Tangible assets, Limited number of intangible assets and liabilities</td>
</tr>
<tr>
<td>Revaluation</td>
<td></td>
<td>Financial assets, through Fair Value Option</td>
</tr>
<tr>
<td>Fair value (through statement of income)</td>
<td>IAS 39, IAS 41, IFRS 2, IAS 19, IAS 37</td>
<td>IAS 39, IAS 40</td>
</tr>
<tr>
<td>Fair Value (through equity)</td>
<td>IAS 39, IAS 19</td>
<td>Financial assets or liabilities, through Fair Value Option, Investment properties</td>
</tr>
</tbody>
</table>

Figure 1.1 The use of valuation models according to IFRS (Marton, 2008)

1.5 The IFRS 13, Fair Value Measurement

1.5.1 The development of the IFRS 13

When implementing a new IFRS there are some things that need to be considered, which are described in the IASB’s “Due Process handbook” (IFRS, 2011c). Here, a description of the development of IFRS 13 will follow. First of all, the IASB published a discussion paper that described their view on fair value measurement. The discussion paper was published in November 2006 with a six-month comment period (ibid.).

The exposure draft for Fair Value Measurement was published in May 2009 after taking in to consideration the 136 comment letters that the IASB received after publishing the discussion paper (IFRS, 2011c). The exposure draft proposed a definition of fair value, a framework for measuring fair value and disclosures about fair value measurement. This exposure draft had a four-month comment period, a summary of the comment letters was presented and the Board discussed the comments (ibid.). One of the most common comments received was a request for the IASB and the FASB to work together to develop a standard about fair value measurement and disclosures (IFRS, 2011b).

To solicit feedback on the proposal in the exposure draft the IASB held public meetings in London, Norwalk and Tokyo as well as non-public meetings in Kuala Lumpur and Singapore (IFRS, 2011c). In April 2010 the IASB decided to issue a
proposed new disclosure on the basis of the re-exposed criteria in the “Due Process Handbook”. This was published in June the same year with a three-month comment period (ibid.).

In 2005 the project of the new IFRS 13 began as a part of the Memorandum of Understanding between the IASB and the FASB (IFRS, 2011c). This means that now, the US GAAP and the IFRS have the same content and definition regarding fair value and the same disclosure requirements about fair value measurements. The project started before the financial crisis hit the world, but still the global crisis emphasised the importance of having similar standards regarding fair value measurement. Two things that the global financial crisis highlighted was the need to clarify how to measure fair value when the market for an asset or liability becomes less active, and the need to improve the transparency of fair value measurement (ibid.).

In May 2011 the IFRS 13 was issued by the IASB, and all members of the Board approved the IFRS for issue (IFRS, 2011c). The IFRS 13 is effective from January 1st 2013, but early application is permitted (IFRS, 2012).

1.5.2 The objectives of the IFRS 13

The IFRS 13 defines fair value and requires disclosures about fair value measurements (IFRS, 2012). The disclosure requirements and measurements of the IFRS 13 apply when another IFRS permits or requires the item to be valued at fair value, but the IFRS 13 does not determine when an item should be measured at fair value (IFRS, 2011d). By establishing the new IFRS 13, IASB wanted to achieve four goals (IFRS, 2011c):

• Reduce complexity and improve consistency in the application of fair value measurement.

• Communicate the measurement objective more clearly by clarifying the definition of fair value.

• Improve transparency by enhancing disclosures about fair value measurements.

• Increase the convergence of the IFRS and the US GAAP.

1.5.3 The Fair Value Hierarchy

To increase consistency and comparability of fair value measurement, the IFRS 13 established a fair value hierarchy based on the inputs to valuation techniques (KPMG, 2011). The fair value hierarchy in the IFRS 13 is based on the FAS 157 (PDN). The inputs are categorised into three levels. Level 1 should be used primarily, if not possible, level 2 should be used and eventually level 3 (KPMG, 2012). The division depends on the identifiability of the specific object in question (ibid.).
Level 1 inputs are unadjusted quoted prices in active markets, for identical assets or liabilities, that is accessible for the entity on the measurement date (KPMG, 2012). An active market is defined as a market in which transactions for the asset or liability take place with sufficient frequency (ibid.). The IFRS gives the highest priority to level 1 inputs since it provides the most reliable evidence of fair value and should generally not be adjusted (Deloitte, 2012a). However, the standard provides a few limited circumstances in which an adjustment may be appropriated (ibid.).

Level 2 inputs are other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly (KPMG, 2012). Inputs are observable if they are developed on the basis of available information about actual events or transactions and reflect the assumptions that market participants use when pricing the asset or liability. The definition of market participants includes the knowledgeable and willing parties in an arm’s length transaction (ibid.). According to Deloitte (2012a) Level 2 inputs include:

- Quoted prices for similar assets or liabilities in active markets.
- Quoted prices for identical or similar assets or liabilities in markets that are not active.
- Inputs other that quoted prices that are observable for the asset or liability.
- Inputs that principally comes from, or are confirmed by, observable market data.

Level 3 inputs are unobservable inputs for the asset or liability and it is the least reliable level (KPMG, 2012). Unobservable inputs are used when relevant observable inputs are not available and when there is little, if any, market activity for the asset or liability at the measurement date. An entity develops unobservable inputs by using the best information available under the given circumstances. This might include the entity’s own data, taking into account all information about market participant assumptions that is reasonably available (ibid.).
1.6 The GIPS Standards

The CFA Institute is a non-profit association of investment professionals with the mission: “leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence” (GIPS 2010, s IV). The CFA Institute has developed the GIPS with the goal to establish it as the recognized standard for calculating and presenting investment performance around the world (GIPS, a). Organizations in 32 different countries has partnered with the CFA Institute to contribute to the development and promotion of the GIPS standards (ibid.).

1.6.1 Background of the GIPS Standards

A global industry initiative, with participation of individuals and organizations from more than 15 countries, started the development of the GIPS standards (GIPS, 2010). In 1995, the CFA Institute sponsored and funded a committee to develop global standards for calculating and presenting investment performance. In 1998 the proposed GIPS standards were posted on the CFA Institute’s website. The proposed standards circulated for comments, which resulted in the first GIPS, published in 1999 (ibid.). In 1999 the committee was replaced by a council that worked for further development and promotion of the GIPS standards. The GIPS standards are continually updated through interpretations, guidance, and new provisions in order to maintain global relevance. The CFA Institute consider fair value measurement to be the most relevant measurement basis, and they are very positive to the use of fair value measurement for all assets and liabilities (ibid.).

1.6.2 The objectives of the GIPS Standards

The GIPS Executive Committee, which was created by the CFA, is a decision-making authority for the GIPS standards (GIPS, 2010). The goals of the GIPS Executive Committee are (ibid.):

- To establish the best practices for calculating and presenting investment performance that promotes investor interests and gains investor confidence.
- To obtain worldwide acceptance of a single standard based on the principles of fair representation and full disclosure.
- To promote the use of correct and consistent investment data.
- To encourage fair global competition between entities without creating barriers to entry.
- To promote the notion of industry “self-regulation” on global basis.

The CFA Institute states that the GIPS standards are needed for three major reasons: as a standardized investment performance, as a global passport and for investor confidence (GIPS, 2010). The standards mainly benefit investment management from the GIPS firms and investing or prospective clients (GIPS, 2010).
The need to standardize the calculation and presentation of investment performance comes from the growth of financial entities, the globalization of the investment process, and the increased competition among investment management firms (GIPS, 2010).

The GIPS standards are needed as a global passport because asset managers and both existing and prospective clients benefit from an established global standard (GIPS, 2010). If all countries use a global standard, firms in countries with minimal or no investment performance standards will be able to compete for business on equal terms as firms from countries with more developed standards (ibid.). This creates a common playing field for firms (GIPS, 2009).

Investor confidence is gained by a global standard since investment managers help investors to assure that the firm’s investment performance is complete and fairly presented (GIPS, 2010).

1.6.3 The Valuation Hierarchy

The GIPS Valuation Principles were developed with consideration of the work done by the IASB, the FASB and other organizations (GIPS, 2010). The GIPS standards are based on the ethical principles of fair presentation and full disclosures. The GIPS standards are shifting to a broader fair value requirement, and for periods starting on or after January 1st 2011, the GIPS standards require firms to use the fair value methodology following the definition and requirements of the GIPS standards (ibid.).

Firms must use the objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available (GIPS, 2010). If those market prices are not available additional steps are necessary (ibid.):

- Objective, observable quoted market prices for similar investments in active markets.
- Quoted prices for identical or similar investments in markets that are not active.
- Market-based inputs, other than quoted prices, which are observable for the investment.
- Subjective unobservable inputs for the investment where markets are not active at the measurement date.

If objective, observable, unadjusted quoted market prices for identical investments in active markets are not available, firms should value by using the next step (GIPS, 2010). If those prices are not available or appropriate firms should go on to the next step after that and so on. The valuations should be made of a qualified independent third party (ibid.).

Firms must document their valuation policies, procedures, methodologies, and hierarchy, and apply them consistently (GIPS, 2010). They should disclose any changes to valuation and/or methodologies and must disclose the use of subjective unobservable inputs and the key assumptions used to value portfolio investments (ibid.).
1.7 Different views of fair value

1.7.1 The European Financial Reporting Advisory Group

The European Financial Reporting Advisory Group (EFRAG) is a private sector body, which was set up in 2001 to assist the European Commission in the endorsement of the IFRS by providing advice on the technical quality of the IFRS (EFRAG, 2012).

The EFRAG was one among many others who commented on the Exposure Draft of Fair Value Measurement. The EFRAG broadly supported the framework that was described in the Exposure Draft and welcomed the decision of the IASB to provide guidance on how fair value can be estimated (EFRAG, 2012). However they did believe that some parts of the Exposure Draft were inappropriate (ibid.).

Among other things the EFRAG pointed out their concerns about the reliability of level 2 or 3 measures because of the absence of active markets (and sometimes even markets of any kind) (EFRAG, 2012). They stated that if an active market does not exist it is difficult to achieve the desired objectivity that the IASB wants to obtain with the market participant-based measurement basis. The new definition in the IFRS 13 clarifies that fair value is a market participant-based notion rather than an entity-specific notion. According to the EFRAG, using a market participant-based notion means that entity-specific cash flows containing information that users of financial statements find useful, would be ignored (ibid.).

Particularly, the EFRAG was negative towards the valuation of all assets and liabilities at fair value (EFRAG, 2012). The EFRAG had doubts that fair value, as defined in the Exposure Draft, would be the most useful measurement for non-financial items. The EFRAG did not accept the new definition of fair value for most non-financial items since the EFRAG believed the definition would be unclear and difficult to understand and apply. The EFRAG also stated that the new definition would lead to internally inconsistence (ibid.).

1.7.2 Other views

There are several benefits using fair value instead of other valuation methods. Fair value satisfies the requirements of caution since assets cannot be overvalued and liabilities cannot be undervalued (Marton, 2008), and this provides a more realistic, faithful and accurate view of the position of a firm (Lindsell, 2005). Marton (2008) also believes that fair value provides greater information than i.e. historical cost and that it will lead to accounting of higher quality. The IFRS 13 provides a uniform definition of fair value among various standard setters and firms around the world, which is good for the harmonization of standards (Nordlund, 2012).

One negative cause of fair value is that it is difficult to establish objective fair values, which implies that fair value is difficult to verify (Nordlund, 2012). This because, in many cases, there are no active markets and the fair value is therefore an assumption rather than a relevant value. Nordlund (2012) believes that standard setters should spend more time discussing this subject, and discuss whether this kind of fair value belongs in the financial statements or not.
1.8 Summary

One of the most important debates in accounting is what assets and liabilities are worth. In the traditional theory of accounting, historical cost has been used and it has been the far most fundamental and common model. Today the IASB and the FASB consider fair value to be the most relevant measurement basis, and since the IASB introduced fair value as the primary basis of measurement its popularity has grown.

The IFRS 13, Fair Value Measurement, was issued in May 2011 by the IASB. The purpose of the standard is to reduce complexity and improve consistency in the application of fair value measurement, to communicate the measurement objective more clearly and to improve transparency by enhancing disclosures. It is also important that the information in the financial statements is useful and correct. The IFRS Conceptual Framework specifies four important qualitative characteristics that makes the information useful: understandability, relevance, reliability and comparability. One of the steps to increase consistency and comparability in the fair value measurement was to implement the fair value hierarchy in the IFRS 13. The fair value hierarchy is based on the inputs to valuation techniques and gives the highest priority to Level 1, quoted prices in active markets for identical assets or liabilities. The lowest priority is given to level 3 inputs.

The GIPS Standards were developed by the CFA Institute with the goal to establish the GIPS Standards as the recognized standards for calculating and presenting investment performance around the world. The CFA Institute states that the GIPS standards are needed as a standardized performance, a global passport and for investor confidence. The GIPS Standards includes a valuation hierarchy where firms must use objective, observable, unadjusted quoted market prices for identical investments in active markets, if available. If those market prices are not available or inappropriate, additional steps are necessary. The GIPS standards are very positive to fair value measurement and consider that all assets and liabilities should be measured at fair value.

There are many different views regarding fair value. Some consider the measurement to be the most relevant since it is reflecting the actual value. However, some consider fair value measurement to be inappropriate since it is often subjective and based on assumptions.

1.9 Discussion and analysis

This chapter seeks to explain the differences between the definitions of fair value and the content in the different standards; the IAS 2, the IFRS 13 and the GIPS. It also sought to discuss the issues regarding if fair value meets the different criteria for financial reports and the different opinions for and against fair value, and if fair value measurement should be used for all assets and liabilities.

1.9.1 Comparison of the content of the fair value standards

The definition of fair value according to the GIPS standards differs from the definition of fair value according to the IFRS 13. The definition in the GIPS standards is more similar to the previous definition of fair value, i.e. the definition in IAS 2, which was referred to earlier in this chapter. Those two definitions both refer to an amount for which something could be exchanged. In the GIPS and the IAS 2 definitions, it is not specified whether it
is an entry price or an exit price, which might be confusing. The new definition of fair value in the IFRS 13 has a different approach; rather than referring to an amount for which an asset or liability could be exchanged, the new definition refers to a price that would be received to sell an asset or paid to transfer a liability. The fact that the new definition includes the words “sell” and “transfer” implies that it is an exit price rather than an entry price. Many seemed to be positive to the fact that the new definition of fair value in the IFRS 13 is based on an exit price. The fact the exit price is specified in the new definition of fair value helps to reduce the complexity of fair value. However, it should be considered that some aspects might get lost if the entry price is excluded.

The new definition in IFRS 13 also explicitly states that the transaction takes place at the measurement date. In the other two definitions (GIPS and IAS 2), a date for the measurement is not mentioned at all. This shows that the new definition in the IFRS 13 is more distinct, which was one of the purposes of the standard. The definitions, both in the GIPS and the IAS 2, say that the exchange is between willing parties who are knowledgeable. The new definition in the IFRS 13, on the other hand, says that the transaction is between market participants. Since market participants include knowledgeable and willing parties and an even more specified definition, it also leads to a clearer definition and less complexity. Some reasons why the IASB developed the IFRS 13 was to increase transparency, reduce complexity and improve consistency, in other words they believed the old definition was not detailed and clear enough. The CFA Institute has not changed the definition of fair value, which is very similar to the definition of the IASB (i.e IAS 2), why it is questionable whether valuation according to the CFA Institute is fair.

Both the IFRS 13 and the GIPS standards have a hierarchy for fair value measurement and they are similar in many aspects, yet they differ in a few. The hierarchies are adopted to increase consistency and comparability in the fair value measurement. By implementing the hierarchies it will be easier for the users of the financial reports to know how reliable a valuation of an asset or a liability is, as the fair value accounting becomes more transparent. In the IFRS 13 the fair value hierarchy is divided into three different levels, which are given different priorities. The GIPS hierarchy is instead divided into several steps, which also are prioritized. The GIPS standards give the highest priority to objective, observable, unadjusted, quoted market prices for identical investments in active markets on the measurement day. The only difference in the level given the highest priority is that the IFRS 13 refers to assets and liabilities instead of investments. In other words there are no material differences in the hierarchies, and the reason why the GIPS standards use “investments” is because the standards address to financial firms. The similarities between the two hierarchies proceed further down the priorities, and this indicates that the fundamental idea of the hierarchies is similar in the two standards.

1.9.2 The issues of fair value measurement

The Conceptual Framework states how important it is that the information in the financial reports meets certain criteria such as understandability, relevance, reliability and comparability. The question is if fair value measurement always is in compliance with these criteria. When using fair value measurement techniques found further down the hierarchies, this is highly uncertain. As mentioned earlier, level 3 in the IFRS and the lower priority steps in the GIPS allows the entity to use an evaluation model instead of an
existing price on an active market. This means that the value is an estimation that may not be the most correct one.

The information in the financial statements will be more difficult to understand, for the majority of the users, if all valuation models are different. It requires more knowledge about accounting and valuation methods that everyone does not have. And when entities choose their own valuation model it leads to less comparable results, because all entities would probably not choose the exact same way to value their assets and liabilities. The opportunity for entities to choose their own valuation model leads to much more subjective values. The question that arises is if the values are reliable when they are subjective? Information that is not reliable is probably not relevant for making financial decisions either. It is difficult to get a fair value that is objective and relevant because as soon as firms use a lower priority level of the hierarchies, as a result of no active markets, the point of using fair value is lost. Fair value is the most relevant value of assets and liabilities if there is an active market. Often it is not, and that makes the value less relevant. As mentioned earlier, the purpose with financial accounting is that the information should help its users make financial decisions. But if the values in the balance sheet and income statement are assumptions based on mathematic valuations models rather than objective values it is questionable if the information is reliable enough to use when making decisions? The questions mentioned above imply that the fair value measurement is not always in compliance with the criteria from the Conceptual Framework.

However, the new fair value standard will help users of the financial reports to make comparisons between firms, since the IFRS 13 provides fair value a uniform definition among standard setters. Further, this leads to a more fair global competition between entities. Many believe that fair value provides relevant information and a more realistic, faithful and accurate image of the firm than historical cost does. Using fair value therefore helps when investors and analysts want to get access to the firm’s current, rather than historical, financial position. Historical cost is relevant at the acquisition date, and only at that day. Since it is a fixed value that does not follow the market, it becomes “old” as soon as the value of the asset or liability changes, which it frequently does. Using historical cost therefore makes it more difficult to assess what assets and liabilities currently are worth. The historical cost does not take the unrealized changes in value into consideration, and this might result in misleading information about the firm. Fair value on the other hand is flexible and changes with the value on the active market. Therefore fair value is a more accurate and “reality-based” value than historical cost for some assets and liabilities, as supported by both the CFA and IASB in their standards where they both expressed fair value as the primary basis of measurement.

The new definition of fair value in the IFRS 13, including exit price, makes the fair value measurement market-based rather than entity-based. As the EFRAG states, this might lead to that the entity-specific information gets lost. There are several benefits with a market-based measurement; however, the fact that entity-specific information is overlooked leads to that the users of financial statements do not get all the information they might want. If the users do not get all the information they need, it is less possible that the users make good investment decisions.

The GIPS standards believe in a wider use of fair value, where firms measure all assets and liabilities at fair value. This is partly because the GIPS address to financial firms, assets and liabilities, for which fair value is regarded to be the most relevant valuation method. However, it is reasonable that all firms, even the financial ones, have
non-financial assets or liabilities, and this might be a problem when it comes to valuing these non-financial assets or liabilities at fair value. The IFRS, on the other hand, does not require fair value measurement for all assets and liabilities, even though the IFRS often prefer the fair value method. As mentioned before, fair value is regarded to be the most relevant and useful measurement for financial assets and liabilities, which probably is the reason why fair value measurement is mandatory for financial assets in both the IFRS and the GIPS. The EFRAG believes in an even narrower use of fair value measurement than both the GIPS and the IFRS. The EFRAG expressed their concerns for fair value regarding valuation of assets and liabilities using the lower priorities of the hierarchies. However, the GIPS standards still believe in fair value for all assets and liabilities, but what needs to be taken into consideration is that the GIPS is addressed to financial firms. It is known that financial assets and liabilities would be best measured at fair value but an interesting thought is if the CFA Institute would still believe in a full use of fair value if they also addressed to other than financial firms.

One thing that the EFRAG were especially negative about regarding IFRS 13 was the valuation of non-financial assets at fair value and considered the definition to be unclear and difficult to understand and apply. It is more difficult to find active markets for non-financial assets, and as previously mentioned, the absence of active markets result in less objective and reliable values. With less objective and reliable values it is more difficult for the users of financial reports to interpret the information, and in other words the criteria stated by the Conceptual Framework, might not be fulfilled. This further demonstrates the complexity of fair value measurement.

1.10 Conclusion

Fair value is a very complex subject. There are various definitions of fair value, but with the new standard IFRS 13, the definitions harmonize. The opinions regarding fair value differ and it is obvious that there is no valuation method that is impeccable. Measuring all assets and liabilities at fair value is inappropriate; however, for some assets and liabilities it seems to be the best choice.

1.11 Questions

- What are the pros and cons of fair value?
- Since the IFRS 13 does not change when to apply fair value, what does it change?
- Explain the differences between the IFRS 13’s and the GIPS’s approaches to fair value.
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Section 2
Convergence of accounting standards and auditor’s work tasks
Chapter 2
The challenges of accounting standard convergence – with focus on IFRS and US GAAP

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2.1 Introduction

The urgent need for a common set of international accounting standards is extensive and both investors and other stakeholders all over the world demand it (Doupnik and Perera, 2012). The two main international frameworks are International Financial Reporting Standards (IFRS) and US General Accepted Accounting Principles (US GAAP). IFRS is used in approximately 120 countries and US GAAP is, as the name indicates, used in the US; one of the largest and most liquid capital markets in the world. Thus, the development of a common international set of accounting standards is an important area that affects a lot of enterprises (ibid). The two boards that develop the standards, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), have since 2002 worked on converging the two standards in order to develop a set of common, high quality standards (Memorandum of Understanding, 2002). This would facilitate comparison between enterprises, both domestic and international, and it would reduce costs in translating and consolidating financial statements (Doupnik and Perera, 2012). It would also facilitate the international trade of goods, services and foreign direct investments. However, there are many problems in developing international accounting standards and it is easier said than done. Factors that affect are culture, nationalism, taxes, and regulations and also enterprises that want to influence the standard setters. It is a time-consuming work and the boards are still working on the development of a common set of standards (ibid).

The questions that arise and which attempts to be answered more thoroughly in this chapter are why there is a need for convergence between IFRS and US GAAP and what problems that are faced while trying to achieve it.

After reading this chapter the reader should be able to:

• Understand the meaning of convergence
• Describe the reasons for why accounting differs between IFRS and US GAAP
• Have an insight into the project of achieving convergence in international accounting
• Have an assumption about the future development within the convergence between IFRS and US GAAP

2.1.1 Disposition

The first part of this chapter will give an insight to the difference between the terms harmonization and convergence, and also investigate the reasons for and against convergence. The following part will give a description of the Memorandum of Understanding (MoU) which contains an agreement of developing one set of international standards, the role that the governmental authority the Securities and Exchange Commission (SEC) plays in the convergence project and the main differences between US GAAP and IFRS. Later on, a deeper discussion about the obstacles to global financial reporting comparability will be given. The last part of the chapter will analyze and discuss the facts presented in previous parts. The analysis will lead to a conclusion where the questions asked in the introduction will be answered.

2.1.2 Definitions

This section provides some important definitions, which are essential for the reader in order to fully understand the chapter.

*International Accounting Standards Board (IASB)* – An independent standard-setting body responsible for developing International Financial Reporting Standards and promoting the use and application of these standards.

*Financial Accounting Standards Board (FASB)* – A private, non-profit organization with the primary purpose of developing Generally Accepted Accounting Principles within the US.

*Securities and Exchange Commission (SEC)* – A federal agency in the US, which holds primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation’s stock and options exchanges, and other electronic securities markets in the US.

*International Financial Reporting Standards (IFRS)* – Set of accounting standards developed by IASB. The main objective is to develop a single set of high-quality, understandable and globally accepted standards.

*US Generally Accepted Accounting Principles (US GAAP)* – Accounting rules developed by the FASB, used to prepare, present and report financial statements for both publicly traded and privately held companies in the US.

*Memorandum of Understanding (MoU)* – An agreement established in 2002, which main goal is to achieve convergence between the IASB and the FASB.

2.2 The difference between harmonization, convergence and comparability

Even if accountants use the same rules while preparing financial statements differences can arise (Doupnik and Perera, 2012). Why is this? No rules govern all possible outcomes or describe every little detail. Therefore, there is room for interpretation. This interpretation, even if it should not be biased, is usually dependent on the accountant’s
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environment and personality. The rules can also differ, not only between countries but also within them, e.g. rules for small entities differ from multinational entities. To comprehend the MoU and the collaboration between the IASB and the FASB there needs to be an understanding of the expressions harmonization and convergence. Harmonization is a process to increase the compatibility in accounting practices by limiting the alternatives. Countries can have different standards as long as these do not conflict with each other. The objective is to keep flexibility but still facilitate comparisons. Convergence means having only one standard throughout the world. That is, reducing the international differences that occur in accounting by developing high quality standards in cooperation with national standard setters (ibid). This leads to comparability; financial statements are only relevant as long as it is possible to compare them to other periods or companies. To be able to compare statements they need to be consistent (Nobes and Parker, 2010).

2.2.1 Reasons for convergence

The main argument for convergence is that it is essential to globalize the capital markets (Doupnik and Perera, 2012). The comparability of financial statements facilitates investors to evaluate foreign securities and make decisions about future investments. That also gives the investor the advantage of reducing risk by investing in different countries. Convergence is also argued to reduce the costs for companies wanting to cross-list their stocks in foreign markets by not having to prepare several different financial statements according to other standards. To be cross-listed on many stock exchanges gives the company access to more financing and more investors can buy their shares (ibid).

Another argument for convergence is that it makes it easier for multinational enterprises to evaluate possible takeovers in other countries (Nobes and Parker, 2010). A lack of convergence might make investors more risk adverse and they will therefore require a higher premium on the expected return on their investment (Doupnik and Perera, 2012). A global system for accounting would reduce the costs of preparing consolidated financial statements and facilitates the auditing of these. Finally, convergence would improve the quality of financial statements internationally and thereby improve their credibility (ibid).

2.2.2 Reasons against convergence

The greatest reason against convergence is the big differences that exist in accounting today, and it would take a lot of time and money to eliminate these problems (Doupnik and Perera, 2012). Another obstacle to convergence is nationalism (Nobes and Parker, 2010). This shows in the unwillingness to embrace new standards originating from foreign countries and the worry to lose a country’s sovereignty. A lack of interest and knowledge about other accounting standards makes convergence problematic (ibid). To find principles that fit everyone involved seems to be impossible and that makes convergence hard to achieve (Doupnik and Perera, 2012). Also, the need for convergence is not globally accepted and many argue that because there already is a well-functioning global capital market there is no need for it. Capital markets already make companies prepare statements according to certain standards in order to list on their exchanges. Opponents feel it is unnecessary to make all companies worldwide follow the same
standards and it creates a "standards overload". This is because companies are made to follow standards that are irrelevant to their particular situation (ibid).

2.3 The convergence process

2.3.1 Memorandum of Understanding

The IASB and the FASB (collectively, the “Boards”) made an agreement in September 2002 to develop “high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting” (Memorandum of Understanding, 2002). This MoU is known as the Norwalk Agreement, and it was the first cooperation agreement between the two boards (ibid). The demand for convergence was nothing new, so why had an agreement not taken place earlier? According to Sir David Tweedie (2007), after the Enron-scandal and the WorldCom-scandal were revealed in the US in 2001-2002, the FASB had to act. The SEC and the FASB have been positive to international standards for a long time (ibid), but suspicious to IFRS and principles-based accounting (Doupnik and Perera, 2012). After the scandals, the FASB realized that their accounting standards were not flawless and the result was the Norwalk Agreement (ibid).

The purpose of the MoU was to eliminate the differences in accounting standards between the two regulators (Memorandum of Understanding, 2002). The aim was to converge their different standards as soon as possible and continue to work together in the future to ensure that the standards maintained compatible. Note that the agreement did not treat any standards in particular; it was just an agreement of cooperation (ibid).

2.3.2 Progress in the Memorandum of Understanding

In February 2006 the IASB and the FASB continued to develop the MoU to confirm the commitment between the two boards (Memorandum of Understanding, 2006). One substantial reason for the agreement was that the Boards hoped that non-US companies, who used IFRS, would be able to register on the US exchanges. The removal of the reconciliation requirement would nevertheless depend on other parties and stakeholders, and it was the SEC who was authorized to make the final decision (ibid).

According to the MoU (2006), the priority for the Boards was to establish global high quality standards. To be able to achieve that goal they based the MoU on the following three principles:

- Convergence through development of high quality standards
- Develop a new common standard
- Replace standards in need of improvement

The Boards focused on two perspectives, a short-term and a long-term. The former only included a few projects, which made it possible for the Boards to focus on other important areas such as; fair value option, impairment, income tax and research and development. The Boards also decided to work on eleven long-term projects, e.g. revenue
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recognition, fair value measurement and consolidations. Until 2008, the objective with these projects was to create a foundation and “measurable progress” rather than to fulfill complete standards (ibid). The FASB and the IASB would at the same time work on their joint conceptual framework project, which would be influenced by both IFRS and US GAAP (Doupnik and Perera 2012).

In 2007 the SEC allowed non-US companies that did not use US GAAP, but were registered on the US stock exchanges, to report in accordance with IFRS (IFRS, 2012). This decision facilitated and reduced costs for many enterprises and fulfilled one of the goals with the MoU (Memorandum of Understanding, 2002, 2006, 2008). Additionally, the European Commission suggested that the European Union should eliminate possible needs for the companies that used US GAAP and had securities in European capital markets to reconcile their financial reports to IFRS (ibid, 2008). In 2008 an updated version of the MoU was published and progress reports have been published quarterly after 2008 (IFRS, 2012). The timetable has changed and will continue to change over time and a reason for this is that the FASB and the IASB is dependent of stakeholders’ opinion and feedback (Hoogerworst and Seidman, 2012).

2.3.3 The SEC’s role in the convergence project

The SEC was founded in 1934 as a response to the public’s lack of trust for the capital market after the stock market crash in 1929 (SEC, 2012b). To restore investor confidence, the goal was to provide them and the market, with clear rules of honest dealing and more reliable information. The SEC’s main mission is still today to protect investors and every year hundreds of enforcement actions take place because of violations of the securities laws (ibid).

The standards issued by the FASB are recognized as authoritative by the SEC (SEC, 2012b). The SEC is allowed to establish accounting standards, but the organization has, throughout history, relied on the FASB to develop standards. They state that as long as the FASB can prove that they can fulfill this responsibility, they will not interfere with the development of the standards (ibid).

To help the SEC decide whether or not to adopt IFRS, when the adoption would occur and how it was going to proceed, the Commission published a work plan in February 2010 (SEC, 2012a). The latest update of this work plan was released in July 2012. In it, the SEC stated that the report did not imply that they had made any decision about the questions above, as further analysis was needed before a decision could be made (ibid). However, the question on how to incorporate IFRS has been discussed earlier (SEC, 2011). Some suggestions in this matter have been provided, which include for example full adoption of IFRS on a specified date, full adoption of IFRS over several years, an option to apply IFRS or retention of US GAAP with continued convergence efforts. The work plan report from 2011 included a suggestion of an approach that was called “condorsement”. This approach can be explained as a mix of the convergence approach and the endorsement approach. An endorsement approach is when a country incorporates individual IFRS standards into their local GAAP. With this approach, the degree of deviation from IFRS can vary. Some countries adopt the standards exactly as issued, while some countries make modifications or additions to individual standards. This endorsement approach was suggested to be the main approach. However, during the period of transition to IFRS, the suggestion was to use a convergence approach. With a convergence approach, the IFRS is not incorporated directly, but the local GAAP is
maintained with continued efforts of convergence with IFRS over a defined period of time, e.g. five to seven years. After this period, the goal is that a financial report under US GAAP will be compliant with IFRS. The condorsement approach is believed to be the most practical way to incorporate IFRS and could minimize both the cost and effort needed (ibid).

2.4 Main differences between IFRS and US GAAP

2.4.1 Principles versus rules

There is a big difference in the US compared to many IFRS countries that should be mentioned - the legal system (Common Good, 2011). The US is generally known for allowing lawsuits for many different reasons that result in a lot of them. The law is very complex, the US code alone contains about 47 000 pages of statutes to prevent from human error (ibid).

The structure of the American law has resulted in an US GAAP that is embedded through laws and regulation (SEC, 2012a). When the GAAP contains a set of rules that must be followed and is very specific and prescriptive, the approach taken is called rules-based (Investopedia, 2006). The perceived view is that with this approach accuracy in the financial reports can be increased. Many accountants in the US favor this since an absence of rules can result in lawsuits if it turns out that their judgments of the financial statements were incorrect (ibid). According to Agoliga et al. (2010) a common quote in the US is “show me where it says I can’t”. This illustrates the linchpin in rules-based accounting (ibid).

The IASB has a principles-based approach to financial reporting (SEC, 2012a). With a principles-based approach, there is less guidance on how to use the standards. The motive for this is to encourage professional judgment since one situation might be different from another (ibid). The chairman of the IASB declares that with a rules-based approach it is easier for accountants to, instead of using their own judgment, follow a rule or motivate their actions by saying that there is no rule that contradicts them (Doupnik and Perera, 2012). However, the auditing firm Ernst & Young (2011) argues that the two sets of standards are generally more alike than different in the most common transactions that occur and that IFRS is partially based on the same basic principles as US GAAP. They continue by explaining that the frameworks and basic principles of the two sets of standards are alike or sometimes the same, making some accounting results similar (ibid). This is backed up by the SEC who thinks that the FASB, as a result of MoU, has issued more principles-based standards in recent years as opposed to before (SEC, 2012a).

In the Final Staff Report issued by the SEC (2012a), it is said that the US constituents generally perceives IFRS standards as underdeveloped, compared to US GAAP standards. The report emphasizes that there are areas in US GAAP that are also underdeveloped, but that the gap in IFRS is greater. For example, it is said that IFRS is not comprehensive with all types of industries; they have more “industry neutral” principles. US GAAP was developed by various standard setters and many of them attended to address industry specific matters with the goal to provide more relevant information. The SEC finds this a problem since US GAAP provides more guidance for the different industries than IFRS does (ibid).
2.4.2 Standard differences

There are some differences in the standards of US GAAP and IFRS, although many of them have been eliminated due to the MoU project (Memorandum of Understanding, 2008). The Boards are almost done with this process but they have encountered some problems. The Boards have basically executed the short-term projects (ibid). However, when it comes to the long-term focus, they are still working on three standards according to the update report from April 2012 (Hoogerworst and Seidman, 2012). These areas are leasing, revenue recognition and financial instruments. They are also working on a fourth area, insurance contracts. The reason for the delay is that the Boards have had problems to agree with each other and other stakeholders, therefore, they have re-exposed two of the standards; leasing and income recognition. Regarding the standard financial instruments, there are still questions about classification, measurement and impairment (ibid). According to Hoogerworst and Seidman (2012) from the IASB and the FASB, the Boards will probably re-expose that standard as well. The Boards estimate that the standards will be fully developed in the middle of 2013. The Boards point out the importance of feedback from the stakeholders and that their point of view exists in the completed standards. They also emphasize the importance of the standards being elaborated and viable in practice. A few of the standards contain major differences and will therefore be processed further (ibid).

2.4.2.1 Financial instruments

The IASB and the FASB have worked on developing a financial instruments standard and have encountered problems within this area. According to Hoogervorst and Seidman (2012) the major difference is, among other things, classification and measurement of financial assets, and whether or not they should use fair value. In 2010 the FASB published an exposure draft where they suggested that fair value should be used for almost all financial assets. After feedback from stakeholders it seems that some of the assets should be valued by amortized cost accounting. On the other hand, it exists clear categories for asset measurement in IFRS 9, which are fair value or amortized cost accounting. Thus, the fair value question is the major difference in opinion between the Boards. The problem is which assets that should be measured at fair value, when the assets should be recognized and the number of classification categories. The standards also differ in the degree of disclosure requirements where the FASB advocates strict disclosure requirement as a result of feedback from investors. IFRS 9 is mandatory from 2015 but early adoption is permitted (ibid).

2.4.2.2 Leasing

According to Hoogervorst and Seidman (2012), the principal problem with leasing is the off-balance sheet problem and the goal with the new standard is to ensure that all assets and liabilities are recognized on the balance sheet. The draft is that all leases that contribute with a significant risk or benefit should be recognized. The Boards have issued exposure drafts and will issue a revised exposure draft in 2012. The expectation is to have a new standard in 2013 (ibid).
2.4.2.3 Revenue recognition

The revenue recognition standard illustrates the huge difference between the two regulations (Hoogervorst and Seidman 2012). The FASB have industry-specific rules and guidance while the IASB have more unclear principles and their users often look at US GAAP for guidance. The Boards have issued an exposure draft in 2010 and a revised exposure draft in November 2011. Hopefully a new standard will be published in 2013 (ibid).

2.5 Obstacles to global financial reporting comparability

Differences exist across countries when it comes to accounting and financial reporting, and there are a number of factors that could interfere with the goal of establishing one single set of standards that would create a worldwide comparability. Stephen A. Zeff (2007) has written an article in which he discusses four cultures, all of which can contribute to difficulties in the convergence between US GAAP and IFRS. The four cultures he discusses are the following:

- The business and financial culture
- The accounting culture
- The auditing culture
- The regulatory culture

2.5.1 The business and financial culture

In the way business is conducted and in their supporting financial markets, there are certain differences across countries. Different incentives and disincentives in the income tax law have an impact on how business transactions are designed in different countries. One example of this is in the US, where it is common in certain industries to raise financing through long-term leases, in order to benefit from the tax system. This means that financial institutions that lease them to the company would own the assets; therefore the assets do not appear on the lessee’s balance sheet. This creates a considerable lack of comparability both within the same country and between countries.

In both IFRS and US GAAP the term *fair value* is becoming more prominent, especially when it comes to measuring impairment losses and revaluing property, plant and equipment. It is therefore necessary that asset-pricing markets exist to provide these values. However, in many countries, the asset pricing markets are insufficient and cannot provide the necessary data. Companies in these countries would have to use value models or base their estimates on the prices of similar assets, which in turn might produce results

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1 Please note: Section X.5 refers exclusively in context to article *Some obstacles to global reporting comparability and convergence at a high level of quality*, written by Zeff, S. A. 2007.
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that are not comparable with those in countries where there are adequate asset-pricing markets.

2.5.2 The accounting culture

The cultural value of fixating on the minimization of the income tax burden has a strong impact on accounting. The differences here are significant, for example the difference between Germany and the UK, both located in Europe but with a big difference when it comes to tax deduction. In Germany, asset impairment losses are tax deductible whereas they are not in the UK. This might lead to a UK company not recognizing an impairment loss, as opposed to a German company that might show a loss in the financial statement to benefit from the tax deduction. Obviously, this would cause difficulties to compare the two financial statements with each other.

Today, there is also a matter of increasing complexity in company financial reporting; the reports were prior to 2005 less detailed and therefore less daunting to read and understand. Ernst & Young recently presented a study of 65 European companies using IFRS in 2005. The companies reported that they are now required to provide approximately 2000 disclosures in their financial statements, which is about twice the number as under UK GAAP.

2.5.3 The auditing culture

There is a different auditing culture among countries even though, apart from the US, a single body at the international level issues auditing and assurance standards. For example, in some European countries, there has been a tendency for auditors not to issue a qualified report if the company’s financial statements departed from national accounting standards. This has been shown in some countries where the external auditor sometimes does not issue a qualification to a company who clearly is not following the statutory accounting and disclosure requirements. The reason for why an auditor does not issue a qualification may be because it is not wanted by the society that an auditor publicly question a major company for its choice of financial reporting methods. On the other hand, most countries do have a positive attitude towards auditors and see the profession as a way to ensure quality in a company’s financial statements. It is clear that the mentality when it comes to auditing differs across countries and therefore could lead to a diminution in comparability. It is also clear that a company that can depart from the accounting standard without having an auditor discovering it might be more unwilling to follow standards. This makes comparability even more unreliable.

2.5.4 The regulatory culture

Different countries have different traditions when it comes to whether a regulator should take an aggressive stance when dealing with companies’ financial reports or not. These financial reports are destined for both the securities markets and the shareholders. A country that has a statutory authority with a very strong position on accounting matters is the US. Some would say that the SEC is oppressive and many countries would probably prefer a lighter regulatory body. Therefore, it is obvious that the degree of regulation vary in different countries. This in turn affects the degree of how willing a company would be to depart from the accounting standards. It would be more difficult to depart from the
standard in the US compared to a country with a lot softer regulation and this would of course have an impact on the worldwide comparability.

There are some significant factors that can influence the strength of a regulator. How much authority the regulator is given, the size of its budget and how competent the staff is, are some of the factors.

In civil code law countries, a regulator may not be able to require companies to restate their financial statements once the shareholders have improved the company’s financial statements. In common law countries on the other hand, the shareholders do not vote to approve the financial statements during the annual general meeting. Therefore, the regulator could require the company to make a “restatement” if the regulator is questioning one or more assessments in the financial statements. This is common in both the US and the UK.

Despite the four cultures described above, Zeff (2007) stresses some other problems that have to be considered in the project of achieving convergence and comparability of different standards. These are as follows:

- Problems of interpretation
- Problems of language
- Problems of terminology

2.5.5 Problems of interpretation

Interpretations are necessary for the effective implementation of the standards and therefore to the achievement of comparability. IFRS makes room for interpretation and different countries might interpret the standards differently. The International Financial Reporting Interpretations Committee (IFRIC) was created by the IASB in order to propose official interpretations subject to approval by the IASB. However, different countries have regulators that could issue their own interpretations, which makes the application and implementation of IFRS different in one country than another. The Committee of European Securities Regulators (CESR) is working together with the European Commission trying to coordinate regulators in Europe. The International Organization of Securities Commissions (IOSCO) is working on the same thing around the world, with the goal to coordinate the work of the national regulators.

2.5.6 Problems of language

Language is a factor that will always be a problem when translating IFRS from English to the local language. It is not easy, some would say it is impossible, to find the right meaning and translation for all words and concepts. One example is the British concept that the accountants must give a “true and fair view”. The concept has been translated into all the languages of all the European Economic Community (EEC) countries, but it has been hard to find an equivalent meaning to the concept. An even bigger issue is that the concept itself is not always understood. The words may be understood, but the concept may not.
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2.5.7 Problems of terminology

The problems of terminology are based on the different national interpretations and translations. A single term can have different meanings in different countries and cultures. A good example of this is the term probability, which often appears in IFRS, but no one really knows the meaning of the term. Does it mean 60% or 90% likelihood, or something completely different? One certain country may estimate the probability at a high percentage level, while another may adopt a lower, less strict, percentage level. Thus, terms can be defined and interpreted differently from country to country and can therefore complicate the international convergence and comparability.

2.6 Summary

The main argument for convergence is that it is essential to globalize the capital markets. Convergence also aims to provide comparability of financial statements between countries, which facilitates investors to evaluate foreign securities and make decisions about future investments. It is also argued, that convergence would reduce the costs of preparing consolidated financial statements. However, there has been criticism directed towards the convergence process, the most predominant surrounding the big differences that exist in accounting around the world.

Even though the terms harmonization and convergence have been recognized and discussed as an important matter in order to achieve global financial reporting comparability for many years now, it was not until 2002 that the FASB and the IASB formalized an agreement to work together in order to eliminate the differences and to achieve convergence between the two standards. In 2006, the boards expanded the MoU to confirm the commitment between them and yet today, the boards are working together towards the goal of achieving one single set of accounting standards.

The SEC has been positive towards the convergence between the two standards during the whole process, but is concerned with the fact that IFRS is principles-based while US GAAP is rules-based. In 2007, the SEC allowed non-US companies that did not use US GAAP, but were registered on the US exchanges, to report in accordance with IFRS. This decision facilitated and reduced costs for many enterprises and fulfilled one of the goals with the MoU. The SEC is currently working on when and how to incorporate IFRS in a way that suits all parts involved in the process.

When confirming the commitment to work together towards convergence, the FASB and the IASB decided on certain convergence projects that needed to be completed in order to develop a single set of accounting standards. Most of these projects have been completed, but the boards have faced some problems in the process and are still working on three standards that are not yet completed. These standards are leasing, revenue recognition and financial instruments.

Furthermore, it has been argued that it would be difficult to converge two standards that have different principle approaches and legal systems. Therefore, it is of interest to further discuss the obstacles in the ongoing convergence process and how they may affect the future development within the convergence between IFRS and US GAAP.
2.7 Analysis and discussion

This part of the chapter will analyze the differences and obstacles that are brought up in the main text. The differences that might remain even if convergence between IFRS and US GAAP is achieved will also be discussed. The section ends with some thoughts about the future of the convergence process.

2.7.1 Barriers in the convergence process

Both the FASB and the SEC are positive to the convergence of accounting standards (Tweedie, 2007). A relevant question today is whether IFRS is similar enough to US GAAP that a decision about adoption of IFRS is ready to be made.

One of the challenges for the FASB is the improvement they need to make to US GAAP while at the same time work with the longer term reporting solution with the IASB. The risk might be that the two tasks collide. If changes to US GAAP but not IFRS are being made, the process of convergence is slowing down. This might be a part of the reason for the constant postponement of the project end date and the decision from the SEC about whether to adopt IFRS or not. The decision is planned to be made in 2012 (SEC, 2012a). In July 2012 the SEC released a final staff report were they made clear that the report did not imply that a decision had been made yet (ibid). As of now, in October 2012, this fact remains.

2.7.1.1 Rules versus principles

First and foremost the reader has to understand that the IASB and the FASB are more alike than different regarding the most common transactions (Ernst & Young, 2011). The general principles and the conceptual frameworks are alike within the different sets of standards and therefore lead to similar accounting results (ibid). According to Ernst & Young (2011) and the SEC (2012a) many believe that IFRS is principles-based and that US GAAP is rules-based but this view is not unchallenged. Others argue that both sets of standards are principles-based, although US GAAP provides more guidance and interpretations to their principles (ibid). The FASB started out with a principles-based approach but regulatory environmental circumstances such as lawsuits and the general legal system might be one reason for why they have become rules-based. One of the problems that the SEC stresses in their last report is the lack of guidance within the IASB (SEC, 2012a). They are afraid that the IFRS has too much flexibility and that this will lead to a lack of comparability. IFRIC issues some interpretations but these are according to the SEC not enough (ibid). The IASB has historically been reluctant to issue guidance and interpretations, but if they publish more of these, IFRS might become more rules-based in the future.

The differences that arise in financial reporting today depends on several factors, for example what type of business, type of transaction, interpretations of the more general IFRS, industry practices and the choices available in accounting in the sets of standards (Ernst & Young, 2011). The SEC argues that IFRS has more alternatives to choose from and too few interpretations (SEC, 2012a). However, whether rules or principles are the best option is hard to determine. If the Boards want to move towards convergence, one or both of them have to approach the other party. The IASB aims at being principles-based and there is a long way to go if the US wants to be the same. A lot of industry-specific
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guidance has to be changed or eliminated and the same with certain laws and precedents. If the IASB moves toward the FASB they will probably end up with more guidance to their standards and become rules-based just like the FASB. Since the fundamental view in US is based upon the quote “show me where it says I can’t” (Agoliga et al, 2010), it may be complicated to change to principles-based accounting. This attitude, in combination with the lawsuits tradition, might result in problems during the process of adopting IFRS and principles-based accounting.

2.7.1.2 Other obstacles

As discussed in chapter X.5, there are, according to Zeff (2007), other obstacles than rules versus principles on the way towards one converged set of standards. The first obstacle that Zeff stresses is the differences in business and financial culture that exist worldwide. For example, different incentives and disincentives in the income tax law have an impact on how business transactions are designed in different countries. One certain accounting approach will therefore determine whether a transaction will appear in the financial report or not (ibid). It is obvious that differences like these create a significant lack of comparability between financial statements, both domestic and international, and it is likely that it creates problems for The Boards to converge US GAAP and IFRS.

The obstacles that Zeff discusses can be very hard to overcome and will most likely lead to differences in financial statements between countries. How big these differences are, and where the line is drawn for how big they are allowed to be for enough convergence to be achieved, is an interesting question to ask. According to Doupnik and Perera (2012), one of the major goals with convergence is to make financial reports comparable. There are several ways for a country to adopt IFRS and the question is in what way the US will adopt it and to what degree they will deviate from IFRS. Through the work with MoU the standards have become more comparable, and there is not many areas left for the two standards to cover. If the project will not end in an adoption of IFRS by the US, some of the original targets with the project will go to waste. However, if it does end with adoption, but with a high degree of deviation, then the standards will be more similar and comparable than before, but it might be hard to claim that full convergence between them has been achieved. It could be discussed if full convergence is possible to achieve, or if it is even necessary. This will be further developed in the next section.

2.7.2 Differences in accounting despite convergence

Even though convergence eventually might be achieved between IFRS and US GAAP, it is of interest to look further into if it still exists factors that will lead to differences between financial statements. In other words, it is not given that convergence will lead to complete comparability between US GAAP and IFRS. What problems in comparability could accrue despite convergence?

If the interpretations of accounting standards are made differently between countries, financial statements among countries will most likely differ as well. Zeff (2007) emphasizes the difference in the auditor’s role across countries and that it will probably affect the comparability. Another dimension on this problem is the different interpretations made by the auditors and that they might allow different transactions,
rules and principles to be undertaken in the financial reports. This could be prevented by using auditing and assurance standards issued by a single body at international level that, according to Zeff (2007), already exist in Europe today. One may therefore ask whether a converged auditing standard is an essential assumption for achieving full convergence between IFRS and US GAAP. Thus, these rules and principles of interpretation go hand in hand with the accounting standards. In summary, even though auditors all over the world would follow a single set of standards, different auditing culture may lead to a lack of comparability between countries.

Other factors that Zeff (2007) stresses are the problems regarding interpretation, language and terminology. These are especially important when talking about comparability, and not convergence in particular. These problems will remain even though one single set of standards is used. It is important to remember that even though IFRS and US GAAP is converged into one set of standards, these standards still has to be translated into several different languages where expressions, terms and interpretations can easily get lost in translation. Further, it is obvious that differences like those described above will cause difficulties to compare financial statements even though the same standard is adopted.

Furthermore, it is important to highlight that auditors and companies have to follow domestic countries’ regulatory systems (Zeff, 2007). Although countries follow the same standards, different regulatory systems will affect how companies are using this common set of standard, which is important to bear in mind. The differences in accounting culture between countries have negative effects of the comparability between countries using the same accounting standard, and will probably remain if full convergence between IFRS and US GAAP is achieved. The terms discussed above are what Zeff (2007) describes as the obstacles for full convergence and to global financial reporting comparability. It should be highlighted that it is likely, but not obvious, that the outcome of convergence between IFRS and US GAAP will be as described above. Another important issue to discuss is whether the two accounting standards will ever be fully converged when there are many factors that could affect the comparison between financial reports.

It should also be questioned whether these problems will remain to the same extent regardless of whether a single, converged standard is achieved, or if two different standards are used between countries. It is not clear that the convergence process will affect the problems of translation and interpretation, which already exist. Maybe, the best outcome we can hope for is an accounting world where the differences between every country’s IFRS exist, but where the differences are minimal so that they still can be understandable by any user around the world.

2.7.3 The future

It is difficult to forecast the future development of the convergence process since the discussion will be built upon conjectures and hypotheses, but the convergence approach should be questioned and it is important to highlight advantages as well as problems. As discussed above, it is unlikely that convergence will ever be fully achieved, and it is not evident that convergence will lead to comparability.

The question one may ask is how far you can go when it comes to eliminate the factors that preclude comparability. It is unlikely that countries are willing to adjust their own laws and regulations, especially in countries with strong regulations, which Zeff (2007) discusses. Furthermore, globalization is important for the implication on these
elements and it is possible to presume that countries interchange and become more alike. On the other hand, globalization can make people more nationalistic and consequently keep and protect traditions. The comparability problem is still a fact, and different regulations will unfortunately not facilitate it.

The project with MoU and convergence has been in progress for ten years and there are still problem areas that are not fully elaborated. The aim was not that the convergence process would take this long, which results in some skepticism regarding if the process will ever be completed. The reason to why the three main standards are still in progress is probably that they are complicated and that the Boards have different opinions in these areas, which in turn require a lot of work to simplify and merge IFRS and US GAAP. Are these standards far too complicated to achieve the main goal to develop a common set of standards? The Boards states that they will reach their cooperation goal (Hoogervorst and Seidman 2012) but as discussed earlier, this fact is questionable.

2.8 Conclusion

This chapter concludes that globalization have contributed to the high demand for a common standard. It would facilitate the comparison between countries and increase the opportunity to transfer capital and reduce costs. It would also facilitate companies to get capital and for investors to fully understand the financial statements. However, the comparability should be questioned and other factors such as auditing and translation will still affect the comparability between the financial statements, even though convergence is fulfilled.

Several obstacles to convergence have been brought up in this chapter. Some are of less concern while some are major. What seems to be the main problem in the convergence process is not factors such as auditing and accounting culture or language, instead, the combination of the fact that the US is a country with a strong regulatory system, generally known for allowing lawsuits for many different reasons and that they use a rules-based accounting approach is seen as the main obstacle for worldwide comparability. It is also important to remember that the adoption of IFRS is a highly political question. The US is one of the largest economies in the world with great power and influence. An important aspect to consider is the fact that the SEC might want to keep this power balance and hence, have influence over the development of future IFRS standards.

2.9 Questions

• What are some advantages and disadvantages of convergence?
• What is the Memorandum of Understanding?
• Which standards are still in progress?
• According to Zeff, which obstacles to global financial reporting comparability exist?
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Chapter 3
The Role of the Certified Public Accountant in Different Countries

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Maria Peiving
Andreas Sandin

3.1 Introduction

Even though the work of a certified public accountant (CPA) has been the subject of harmonization with the help of standards and auditing practices over the years, the auditing is still carried out very differently across the world. An example for the work of harmonization of auditing standards and auditing practices can be found in the EU. Large companies in the private sector whose businesses are located in countries, who are part of the EU, have to carry out their auditing according to the International Standards of Auditing (ISA) (Cassel, 2011).

Reasons behind the differences in the auditor’s work can be many, as an example; cultural values can have an impact on the audit work. For example, the ethical conduct may be influenced by a country’s cultural value and therefore, the perceptions of the auditor’s independence may vary between countries. The education and requirements to become an auditor differ between countries, which can lead to auditing diversity. In Germany it is the law that closely restricts the examination, while in the UK it is the profession itself that are responsible for the examination (Doupnik & Perera, 2012).

Another thing that is likely to influence auditing in different countries is their legal systems. Some countries, like Germany with a codified Roman law system, may require more reliance on how the stated legal objectives for the auditing profession are conducted. Countries with a common law system, like the UK, may rely more on the auditing profession itself to set their own general tone for the profession (Doupnik & Perera, 2012).

These are only a couple of reasons that can influence how the auditing profession is being carried out in different countries. Nevertheless, a couple of questions arise: How is the auditor’s independence affected in different countries, and why does it differ? How can auditing of misconduct be solved through penalties? What are the important aspects of harmonization of auditing, profession and auditing education? To answer these questions, this chapter will focus on comparing six chosen countries to sort out the differences. The countries which are to be compared are; China, Germany, Japan, Mexico, the UK and Sweden. These countries are chosen because of their differences in the explored areas and geographical spread. The explored areas are organizations,
accounting diversity, issues with auditing diversity, education, culture, profession and criminal and civil penalties.

After reading this chapter the reader should be able to:

• Understand the role of the certified public accountant in different countries
• Explain how the education differs between the compared countries
• Describe the culture and profession in the compared countries
• Have an assumption on the connection between accounting diversity, education, culture, profession and penalties
• Understand the problems with auditing diversity

3.2 Disposition

This chapter deals with a number of subjects within auditing, and countries are compared with each other. The first part of the chapter is a statement of the International Federation of Accountants and standards that are of importance for this topic. The second part will cover why there is accounting diversity and how it affects auditing. Thirdly, the education for auditors in different countries is brought up. The fourth part gives an insight to different countries culture. The fifth part is about the auditing profession and sixth part is about what kinds of penalties there are in different countries. The chapter will end with a discussion about the questions asked in the introduction and a conclusion about what the discussion shows regarding those questions.

3.3 International Federation of Accountants

The International Federation of Accountants (IFAC) is a global organization, which deals with questions regarding the professionalism of auditing and accounting consultation, and how to strengthen their power and influence in the economies. By developing, promoting and enforcing international standards for auditing and assurance of high quality, IFAC is serving for the public interest (IFAC, 2012a). IFAC is also active in developing, promoting and enforcing international standards regarding education, ethics and public sector accounting (IFAC, 2012b)

As a result of this, IFAC is supporting the following organizations:

• International Auditing and Assurance Standards Board
• International Accounting Education Standards Board
• International Ethics Standards Board for Accountants
• International Public Sector Accounting Standards Board

(IFAC, 2012b)

IFAC is also supporting the International Accounting Standards Board (IASB) in the convergence project, to achieve one set of standards for international use. Besides from the mission just mentioned, IFAC is serving their member organizations with tools and
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guidance. By doing this, they hope to strengthen the professionalism in emerging economies with the goal to have a strong professionalism of auditing and assurance worldwide. The members of IFAC are professional accountancy organizations from different countries (IFAC, 2012b).

<table>
<thead>
<tr>
<th>Organizations that are members of IFAC, representing countries that are compared in this chapter.</th>
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<tr>
<td>China; The Chinese Institute of Certified Public Accountants (CICPA)</td>
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<td>Germany; Institut der Wirtschaftsprüfer and Wirtschaftsprüferkammer (WPK)</td>
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<td>Japan; The Japanese Institute of Certified Public Accountants</td>
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<td>Mexico; Instituto Mexicano de Contadores Públicos, A.C.</td>
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<td>Sweden; Far</td>
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Figure 3.1 Organizations that are members of IFAC. (IFAC, 2012f)

3.3.1 International Auditing and Assurance Standards Board

As mentioned before, IFAC is supporting the International Auditing and Assurance Standards Board (IAASB, 2012), which is an independent organization with the mission to set international standards regarding auditing and assurance. By setting international standards, IAASB strives for a convergence in the performance of auditing and assurance. IAASB consists of 18 members from different organizations and they work in IAASB for three years before they are replaced. Every year, one third of the members are replaced. IAASB is annually publishing a report of their work, to show their activities and output (IFAC, 2012c).

3.3.2 International Standard on Auditing

ISA is created by IFAC through IAASB (IFAC, 2012d). ISAs are professional standards for the auditor’s responsibility when they are conducting an audit of financial statements. It also includes goals and requirements together with application and other material that explains the standard. In order to understand the standards objectives and to apply its requirements correctly, it is of importance that the auditor has an understanding of the entire text of ISA (Financial stability board, 2012).

The IAASB began a comprehensive project to improve the clarity of ISA in 2004, because the IAASB recognized that the standard needed to be understandable, clear and capable of consistent application. To make it clear means to enhance the quality and make it uniform to practice worldwide. This project involved an essential revision or a limited redrafting of several ISAs. In February 2009, the project was complete (IFAC, 2012d) and auditors over the world had access to 36 updated ISAs (IFAC, 2012e).

The International Standards on Auditing (ISA) is in the interest of this chapter, as it contains principles that countries within the EU have to follow (Cassel, 2011).
3.4 Accounting Diversity

The evidence that accounting diversity exists is seen by the huge differences in profit when comparing the same entity when it is presented by different national GAAPs. In some cases, the difference in profit is enormous. For example, presenting the Brazilian company Braskem SA in the Brazilian GAAP and comparing it to the adjustment made for U.S. GAAP; the difference in profit was 70 percent lower in the US (Doupnik & Perera, 2012).

Theories in accounting diversity are trying to explain factors influencing the diversity in accounting in different countries’ national GAAPs. There are five common accepted factors; legal system, taxation, providers of financing, inflation, and political and economic ties (Doupnik & Perera, 2012).

3.4.1 Why Accounting Diversity?

The legal systems that are used can be divided in two types; common law and codified Roman law. Common law is primarily used in English-speaking countries, and the rules are often accurate and detailed, like the US GAAP. The accounting rules are set by accounting profession organizations, and not in law. The recognition and measurement are more exact, compared with accounting standards set in countries with codified Roman law (Doupnik & Perera, 2012).

In codified Roman law, the rules are more general, than in common law. The accounting law does not usually give precise information on how the accounting should be conducted. Therefore, companies often search for guidance in other laws, for example tax law, and recommendations set by accounting profession organizations. An example of a country that is using cod law is Germany (Doupnik & Perera, 2012).

In many countries, taxation plays an important role in how the accounting is performed. In these countries, tax is the base for calculating income. In other countries, adjustments are made to calculate tax income, after calculating accounting income. In countries with code law, such as Germany and Japan, taxation has a close connection on how the accounting is conducted (Doupnik & Perera, 2012). Another country that also has a strong connection between tax and how the accounting is conducted is Sweden (Kellgren & Bjuvberg, 2008).

How detailed the disclosures are depends on who the providers of financing are. In countries where the banks, governments or family is the main providers of financing, the demand of finance information is often low. Countries where the shareholders are the providers of financing, the demand of detailed disclosures is higher. Government and banks are often represented in the company’s board, if they are the main providers of financing. In companies where the shareholders are the providers of financing, the importance of external information is bigger, for natural reasons (Doupnik & Perera, 2012).

In some countries the inflation remains at a high level all the time, which require adjustments in the accounting. Mexico is an example of a country that previously has experienced high levels of inflation (Doupnik & Perera, 2012).

Political and economic ties explain similarities in accounting between some countries, and why they differ from other countries. U.S. accounting has had an impact on the accounting in for example Mexico, and both England and France has transferred
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their type of accounting to countries where they previously have had colonies in (Doupnik & Perera, 2012).

3.4.2 Accounting Diversity Affects the Work of the Auditor

The legal system is likely to have an impact on the auditors work. Since the accounting rules are set by accounting profession organizations in countries with common law, the auditor should search for guidance from these organizations. The organizations role is to set a general tone for the auditing profession. In countries with code law, the auditor has to rely on the accounting law in a higher degree, compare with countries with common law (Doupnik & Perera, 2012).

In countries where the providers of financing are shareholders and with high demand of disclosures in accounting, companies are likely to have greater needs for the auditor services. Especially compared with countries where the main providers of financing are banks, government and family. In Japan, the providers of financing are often banks, and the demand for the auditor services is therefore low (Doupnik & Perera, 2012).

3.4.3 Issues Regarding Auditing Diversity

Since capital markets have globalized and international capital flows have grown, understanding of cross-national financial reports and audit reports has significantly been heightened. Major variations in many aspects of auditing exist across different countries, and these aspects include audit reports, audit environment, purpose of external auditing and regulation of auditing. The differences in audit environment and regulation of auditing could affect the quality, form and content of audit report (Doupnik & Perera, 2012).

To help the drive towards international convergence of financial reporting standards, it is important that international harmonization of auditing standards are successful. However, the harmonization of auditing standards has been of limited success. If one set of standard was used, that would increase the efficiency of resources in the international capital market and the efficiency of audit process. Therefore, it is important that the work towards an international auditing standard continues. IFAC is responsible for the development. ISA 13, which was established in October 1983, was an important step in the harmonization of audit reports. The presented expression was “give a true and fair view”. That expression required auditors to conduct the necessary auditing procedures to have an expressed opinion. The requirement also satisfies the need for information that international users of financial statements have (Doupnik & Perera, 2012).

EU has worked to harmonize the auditing standard between their members, but it is still not completed (European Union, 2012). In the fourth directive they presented the true and fair view and the eighth directive aimed to harmonize the education and training requirement to become a CPA (Doupnik & Perera, 2012). Companies in EU risk to not be accepted on the international capital market if an audit on their financial statement does not follow the international auditing standard. EU directives states that an audit should be done by a qualified professional, but it do not give any definition, same in terms of audit independence. Studies have shown that there are big differences in what the general public expects from an auditor and what the profession indicates. This difference is a problem because the auditor’s credibility becomes smaller the larger the difference is.
This problem in the end affects the market economy if the general public does not have confidence in the audited financial statements (European Union, 2012).

When it comes to issues regarding auditor's liability, the role of the audit committees and the auditor’s independence, no international agreement has been set on how to deal with it. This is because the regulation is different in different countries (Doupnik & Perera, 2012). Which sanctions an auditor can get, also differs in EU and all around the world, but this subject is treated later in this chapter (European Union, 2012).

3.5 Education

The education and requirements to become an auditor differ between countries, which depends on many things. The legal system is one example, and in Germany the law closely restricts the examination. In the U.K, however, it is the organizations for auditing professions that are responsible of the examination. Culture is another factor that determines how the education is organized, and it also affects the role of the auditor, which is discussed more detailed later (Doupnik & Perera, 2012).

3.5.1 The International Accounting Education Standards Board

Because of the diversity in education, IFAC has established a board for setting standards regarding education within accounting and auditing, named the International Accounting Education Standards Board (IAESB, 2012). IAESB’s mission is to serve for the public interest by developing standards of high quality (IFAC, 2012c).

3.5.2 Education Diversity in Different Countries

In China, the education for audit profession was conducted through a master-apprentice system until the 18th century. In the 18th century, accounting began to teach through universities, but the education is not well developed in comparison with, for example, Germany (Doupnik & Perera, 2012). China does follow IFACs recommendations on examination. The problem is that the education and examination to become a certified auditor in China does not contain equal knowledge compared with IFACs recommendations. In China, the education is more limited and only contains courses related to auditing and accounting. IFAC recommends that the education should be broader and should, for example, contain more general business knowledge (Lin & Hung Chan, 2000).

To become an auditor in Germany you first have to study to receive a university degree, and then have four years of practical experience, including two years of auditing. The Institut der Wirtschaftsprüfer (Institute of Auditors) is responsible for the education and examination of the students, and has stringent requirements on their students (Doupnik & Perera, 2012).

The requirements to become an auditor in Japan are high, but not compared with previous requirements that were extremely high and with low pass rate on the exams. Those who passed were, however, required to go through a three-year apprenticeship. After this period, the students had to pass a difficult exam, and also write a thesis. Recently, the education to become an auditor was reformed, because the requirements were too high, and there is a relative low level of auditors in Japan. Currently, the three
steps of examination have been reduced to one. The internship has been reduced to two years, compared with three years as it was before (Doupnik & Perera, 2012).

In Mexico, the auditors are obliged to have a professional diploma to perform an audit. When completing the examinations, the auditor becomes a CPA, which is called *Contador Publico Certificado* (CPC) in Mexico. Through an agreement between Mexico, the US and Canada, called *the Professional Mutual Recognition Agreement*, the auditor can practice auditing across national boundaries. But for a Mexican CPA to practice accounting in the US, he/she has to pass an exam about the national legislation and standards in the US. In recent time, Mexico has done a lot to improve the accounting and auditing, and to harmonize both the standards and the professional practice of accounting (Doupnik & Perera, 2012).

In the UK, there are four different organizations that are qualified to exam and certify auditors. To become an auditor one has to study relevant courses, have practical experience, and pass the exams (Doupnik & Perera, 2012).

There are two types of auditors in Sweden, the CPA that can audit all types of entities, and the “approved public accountant” who are not allowed to audit all types of entities. To become an “approved public accountant” the requirements is three years of theoretical education and three years of practice experience. After that one have to pass the exam. To become a CPA in Sweden one have to study specific subjects, for example economy and law, a total of four years at a university. After finishing the education, the accountant has to practice accounting and auditing for five years and also pass a final exam. To be able to write the final exam to become a CPA, one has to be an “approved public accountant”. The authorization is regulated in Swedish law (Revisornsämnden, 2012).

### 3.5.3 Summary of the Education in Different Countries

Here is a summary of the educations in the countries that are compared in this chapter.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Summary of the education</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Not well developed. Do not follow IFAC recommendations; only courses in accounting and auditing (no general business knowledge).</td>
</tr>
<tr>
<td>Germany</td>
<td>A university degree is required and also four years of practical experience.</td>
</tr>
<tr>
<td>Japan</td>
<td>The requirements are high. Few passed the exam before. Both theoretical knowledge and two years of practical experience are required.</td>
</tr>
<tr>
<td>Mexico</td>
<td>A professional diploma is required. The CPA can perform auditing in the US and Canada because of an agreement between these countries.</td>
</tr>
<tr>
<td>The UK</td>
<td>Both theoretical knowledge and practical experience are required. There are four organizations that can exam the CPA:s.</td>
</tr>
<tr>
<td>Sweden</td>
<td>Two types of auditors. The CPA is required to have a university degree (four years) and five years of practical experience.</td>
</tr>
</tbody>
</table>

Figure 3.2 Summary of education.
3.6 Culture

As mentioned earlier, the culture of a country can have an impact on the auditing profession. In many ways, the influence of a country’s culture on auditing can make it different from other countries way of auditing. Different ways of auditing is a step away from the work on harmonizing the auditor’s work. Therefore, cultures in different countries are of importance in understanding why there are differences in the auditors work between different countries (Doupnik & Perera, 2012).

The auditor conditions are affected by laws in the current jurisdiction, those who are heads of an organization, the client of the auditor and the people responsible for the governance of the organization that will be revised. In some countries, some aspects of the law give a quite clear expression of the different cultures they have been legislated in. Even in people's attitudes in general, there are large differences. As a result, there are culture differences in the auditors' conditions (Casell, 2011).

Regarding groups of auditors and the cultural difference between them, one aspect can be that the review is focused on the formal correctness of a financial report or on the informative value. This aspect is linked to if the actual group of auditors put great value on either their independent responsibility for the choice of accounting methods or the accountable regulatory compliance. These values are often central in different cultures. When it comes to individual auditors, some might find it natural to question the honesty of the informant and some might find it offensive to do so. Even two independent and impartial auditors might have a different view on loyalty towards their client. One might see loyalty to their client that the company shall be promoted by audit and the other might see it as through auditing the auditor shall receive a basis for accountability or reward of central administration. This shows that there are large cultural variations when it comes to individual auditors (Casell, 2011).

It is vital to understand the cultural differences between countries because even though two audits are carried out according to ISA, it might still show differences if the auditors have different cultural perspectives. When an auditor is planning its audit it can be of importance to know of the cultural difference that might arise to be best prepared and it is also important for the auditor to communicate in a way so that interested parties should not be able to misinterpret the report (Casell, 2011).

3.6.1 Hofstede’s culture dimensions

Hofstede’s cultural dimensions can be used to describe a country’s culture. There are five dimensions and they are power distance (PDI), individualism versus collectivism (IDV), masculinity versus femininity (MAS), uncertainty avoidance (UAI) and long-term versus short-term orientation (LTO) (Hofstede, 2012a). Each country receives a score on each dimension and these scores are relative. They are compared to other countries’ scores and the scores would be meaningless without a comparison. These scores have been proven to be quite stable over decades and they correlate with other data such as power distance is correlated with income inequality and individualism is correlated with national wealth (Hofstede, 2012b). Since the scores are meaningless without comparison, we have looked at the six countries mentioned before; China, Germany, Japan, Mexico, the UK and Sweden for comparison.

PDI is about how less powerful members of a society expect and accept that power is not being distributed among people equally, in other words how society of a country
handles inequalities among people. In a society with a large degree of PDI, people accept a hierarchical order where everybody has a place and in societies with low power distance, it is strived to equalize the power between people. IDV has two sides, individualism and collectivism. Individualism is defined as a society in which individuals are only expected to take care of themselves and their family. Collectivism on the other hand is a society in which individuals can expect that either their relatives or members of a specific group will help them in exchange for their unquestioning loyalty. MAS is whether a society prefers masculinity or femininity. Masculinity means a preference for material reward for success, achievement and heroism. Femininity means a preference for cooperation and caring for the weak. UAI is whether the members of a society are uncomfortable or not with uncertainty and ambiguity. Countries with strong UAI have strict rules on how to deal with uncertainty and ambiguity while countries with weak UAI tend to have a more relaxed attitude in which practice is more important than principles. LTO is whether a society has short-term orientation or a long-term orientation. Short-term orientation means they have great respect for traditions, want to achieve quick results and do not put much effort into saving for the future. Long-term orientation means they are willing to adapt traditions if conditions change, they put much effort into savings and investments and are not that interested in making quick results (Hofstede, 2012a).

3.6.2 Culture of China

The culture in China is associated with high power distance, collectivism, masculinity, low uncertainty avoidance and a focus on long-term orientation, which can be seen in the figure below.

![Figure 3.3 China's cultural dimensions score](https://example.com/figure3.3)

The high score of PDI indicates that Chinese society believes inequalities are acceptable amongst people. Individuals are generally optimistic about people's capacity for leadership and initiative and people should not have high hopes at climbing the ranks. The low score of IDV shows China is a highly collectivist culture, people act more in the interest of the group and not necessarily themselves. Families get preferential treatment
when it comes to hiring and promotions and employee commitment to the organization is low. Relationships between in-groups and out-groups are cold or even hostile at times and the relationships between people are more important than task and company. When it comes to MAS, the score shows that China is a masculine society; they are success oriented and driven. Many Chinese will sacrifice family and leisure to work, just to ensure success. An example is that Chinese students care very much about their exam scores and rankings because that is the main criteria to whether or not they will be able to achieve success. The UAI score is low and the Chinese are comfortable with ambiguity, since their language is full of ambiguous meanings that can be difficult for people from Western countries to follow. The very high score in LTO shows that China is a highly long-term oriented society. Investments in China tend to be in long-term projects and their traditions can be adapted to suit new conditions that might arise (Hofstede, 2012c).

It is said that China does not emphasize independence or the belief in individual decisions (Doupnik & Perera, 2012).

3.6.3 Culture of Germany

Germany’s culture is associated with low power distance, individualism, masculinity, high uncertainty avoidance and a focus on short-term orientation. This will be shown in the figure below.

![Germany's cultural dimensions score](Hofstede, 2012d)

Germany, with its strong middle class and high decentralization, is no surprise to have a low PDI score. Control is disliked and leadership is best accepted when they show expertise. A meeting style that is common is a direct and participative one that also includes communication. The IDV score shows that Germany is a highly individualistic country. A sense of duty and responsibility as well as personal preferences for people is what loyalty is based on and the ideal of self-actualization is strongly believed in. They believe in being honest, even if it hurts and giving their counterpart a chance to learn from their mistakes. The high score of MAS shows that Germany is a masculine society. At the age of ten, the school system separates children into different types of schools because performance is highly valued and early required. When it comes to UAI, the high
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score shows that they are an uncertainty avoidant country. This can be seen in a certain topic or project where details are important, it must create certainty that it is well thought out. LTO is low which means the German society has great respect for its traditions, wants quick results and has small incentives on saving (Hofstede, 2012d).

3.6.4 Culture of Japan

Japan’s culture is associated with medium high power distance, medium individualism, masculinity, high uncertainty avoidance and a focus on long-term orientation, which can be seen in the figure below.

![Figure 3.5 Japan's cultural dimensions score (Hofstede, 2012c)]

The medium high score of PDI shows that Japan is a mildly hierarchical society. Foreigners might see Japan as extremely hierarchical because of their business experience, where every decision takes very long time. The reason behind that is that all decisions must be confirmed by each level in a company and then finally at the top management. As a result of this, there is no top guy in Japanese society that always takes the decision as is in more hierarchical societies. In the education system, it is also noted that everyone is born equal and anyone can become anything. Even though Japanese society has many characteristics for a collectivistic society, such as putting the group’s harmony before individual needs of expressing their opinion, it is not as collectivistic as most of its neighbor countries. One thing the Japanese are famous for are their loyalty to their companies. However, this is something people have chosen for themselves, which is an individualistic thing to do. The high score in MAS means Japan is a very masculine society. Nevertheless, the individual competitiveness that is often associated with masculinity is not seen in Japan. What one sees instead is a high competitiveness between groups. Another expression of masculinity is the drive for perfection and excellence in example their material production. When it comes to UAI, the high score shows they are highly uncertainty avoidant. Since Japan is often threatened by natural disasters, they have learned to prepare themselves for any uncertain situation. This goes for every aspect of their society. Every risk factor must be worked out before any project can start in corporate Japan. This high need for uncertainty avoidance is one of the reasons why
changes rarely happen in Japan. The high LTO is shown in the constantly high rate of investment in research and development, even if economic times are difficult. The companies are not there to make money every quarter but to serve society for many generations to come (Hofstede, 2012e).

### 3.6.5 Culture of Mexico

In Mexico, the culture is associated with high power distance, collectivism, masculinity and high uncertainty avoidance and is shown in the figure below.

![Figure 3.6 Mexico’s cultural dimensions score (Hofstede, 2012f)](image)

The high score of PDI means Mexico is a hierarchical society. People accept that everybody has a place and it does not need any further justification. In organizations it is seen for example that centralization is popular. Mexico is considered to be a collectivistic society, which can be seen by the low score of IDV. Everyone takes responsibility for members in their group and offence leads to shame. Here, loyalty over-rides most other rules in society and regulations. The high score of MAS means Mexico is a masculine society. People “live in order to work”, emphasis in on for example competition and performance and they resolve conflicts by fighting them out. As can be seen in figure 1.4, Mexico has high UAI. That means they have rigid codes of belief and behavior. There is a need for rules and people have an urge to be busy and work hard. Precision and punctuality is very important and innovation may not be wanted. There is no score of LTO for Mexico in Hofstedes dimensions (Hofstede, 2012f).
3.6.6 Culture of the UK

The culture in the UK is associated with low power distance, individualism, masculinity, low uncertainty avoidance and a focus on short-term orientation, shown in the figure below.

![UK Cultural Dimensions Score](image)

Figure 3.7 UK’s cultural dimensions score (Hofstede, 2012g)

The low score of PDI shows a society who believes that inequalities amongst when people should be minimized. The historical British class system is rooted in the belief of the importance of birth rank and on the other hand that where you are born should not limit you. There is a drive that people should be treated in some ways as equals. With a high IDV score, the UK is highly individualistic. They are taught early on to think for themselves and to find out their own purpose in life. The UK is a masculine society, which can be seen by the high score of MAS. They are highly success oriented and driven. The low score of UAI means British are happy to wake up not knowing what the day might bring and it means they are comfortable in ambiguous situations. In work, the result of low UAI leads to planning not being detail oriented. The end goal of work will be clear but the road there is lightly detailed, which means a flexible and fluid process for changing environment. British people are highly creative and have a strong need for innovation. The low score of LTO shows that the UK is a short-term society, focused on quick results. Planning horizons tend to be short and the focus in business is short-term quarterly goals and quick results. For example, the London Stock Exchange focuses on quarterly results to drive stock valuations (Hofstede, 2012g).
3.6.7 Culture of Sweden

The culture in Sweden is associated with low power distance, individualism, femininity, low uncertainty avoidance and a focus on short-term orientation. This can be seen in the figure below.

![Figure 3.8 Sweden’s cultural dimensions score (Hofstede, 2012h)](image_url)

The score in PDI shows that Sweden is a country where for example being independent, equal rights and hierarchy for convenience only is important. Power is decentralized, control is disliked and when communicating it is direct and participative. Sweden is an individualistic country that can be seen by the high score of IDV. There is a high preference to loosely-knit social framework. Individuals are expected to take care of themselves and their immediate families and for example promotion decisions are supposed to be based only on merit. Sweden has a very low score on MAS and is therefore a feminine society. Here, everyone is included and it is important to keep the balance between work and life. An effective manager in Sweden is supportive to his or her people and people value quality in their working lives as well as equality and solidarity. The whole culture is based around the expression “lagom”, which means something close to “not too much or not too little”; everyone has enough and nobody goes without. Lagom is enforced by “Jante Law” which should keep people “in place” and not boast or try to lift themselves above others. The low score of UAI means there is a more relaxed attitude in which practice counts more than principles. People believe there should not be more rules than necessary and should be abandoned or changed if they are ambiguous or do not work. Hard work is undertaken when it is necessary. Sweden is a short-term oriented society with the low score on LTO. That means, as has been mentioned before in other countries; quick results are important and there is a relatively small will to save for the future (Hofstede, 2012h).

As already mentioned, the communication is direct and participative; which is also true concerning the auditors dialog in annual general meetings. In Sweden it is customary practice for the auditor to speak to the shareholders on general meetings. This is something unique for Sweden, compared to other European countries. The auditor speaks
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about the auditing, how it have been organized the past year and the focus areas of the auditing. After the auditor has spoken, it is open for questions (Ekenstam & Flink, 2011).

3.6.8 Summary of the Culture in Different Countries

Here is a summary of the culture dimensions in the countries that are compared in this chapter.

<table>
<thead>
<tr>
<th>Country</th>
<th>PDI</th>
<th>IDV</th>
<th>MAS</th>
<th>UAI</th>
<th>LTO</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>High power</td>
<td>Collectivism</td>
<td>Masculinity</td>
<td>Low uncertainty avoidance</td>
<td>Long-term orientation</td>
</tr>
<tr>
<td></td>
<td>distance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>Low power</td>
<td>Individualism</td>
<td>Masculinity</td>
<td>High uncertainty avoidance</td>
<td>Short-term orientation</td>
</tr>
<tr>
<td></td>
<td>distance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>Medium high</td>
<td>Medium high individualism</td>
<td>Masculinity</td>
<td>High uncertainty avoidance</td>
<td>Long-term orientation</td>
</tr>
<tr>
<td></td>
<td>power distance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>High power</td>
<td>Collectivism</td>
<td>Masculinity</td>
<td>High uncertainty avoidance</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>distance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The UK</td>
<td>Low power</td>
<td>Individualism</td>
<td>Masculinity</td>
<td>Low uncertainty avoidance</td>
<td>Short-term orientation</td>
</tr>
<tr>
<td></td>
<td>distance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>Low power</td>
<td>Individualism</td>
<td>Femininity</td>
<td>Low uncertainty avoidance</td>
<td>Short-term orientation</td>
</tr>
<tr>
<td></td>
<td>distance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 3.9 Summary of culture.

3.7 Professionalism in different countries

There is a range of environmental factors affecting the auditing. How the financial information is used and by who, is affecting the accounting infrastructure; which is affecting how well the profession is developed. In countries where the accounting infrastructure has developed in a higher degree, the profession probably has too (Doupnik & Perera, 2012).

3.7.1 China

Accounting has a long history and a close connection with the development of the culture. In the past accounting was seen as a non-skilled profession. The People’s Republic of China (PRC) was formed in 1949, and with the formation the government decided a policy that meant that all companies should be state-owned. Eventually, this policy proved to be a failure (Doupnik & Perera, 2012).

In the 1980s, an economic reform and an open-door policy was introduced, which resulted in the return of a private auditing profession, supported by the Accounting law
which was added in 1985 and CPA regulation which was added in 1986. This led to the formation of the Chinese Institute of Certified Public Accountants (CICPA) in 1988. CICPA was the first professional accounting body since the PRC. Accounting and auditing took different paths. Auditing firms primarily audited companies with domestic capital and accounting firms were focused on companies with foreign capital. The difference between accountants and auditors, with their own set of rules, was confusing. Therefore, steps were consequently taken to merge CICPA and Chinese Association of Certified Practicing Auditors (CACPA) (Doupnik & Perera, 2012).

In 1993, CPA regulations became CPA law and as a consequence the Ministry of Finance (MoF) was given the authority to regulate both types of firms. Still there are differences between China and other countries. For example, the UK auditors could establish and maintain high quality because they had support from a professional accounting body. The accounting body emphasized education, training and examinations. These support mechanisms are still missing in China. When the government wanted to reform the state-owned companies, the joint stock company was recognized as the desired organizational structure. This resulted in new demands for financial information, partly from investors and other parties. To develop capital markets, two stock exchange markets was established and that led to significant changes in the accounting system. Earlier the government required all new accounting firms to cooperate with a government organization, but the government then encouraged these firms to be independent. Because of the historical connections between the government and accounting firms this was difficult. Today most professional accounting firms still has a connection with some government organization, which is a problem for the auditing profession. China devises uniform accounting systems and auditing systems on national level. In other words, the government regulates the accounting and auditing standards (Doupnik & Perera, 2012).

The lack of sophisticated users and providers of stock information has led to auditors having enjoyed a nearly litigation free environment. China has a relatively low degree of professionalism. Recently, measures have been taken to harmonize Chinese accounting with IFRS and to meet the requirements of economic reform. This has influenced accounting regulation (Doupnik & Perera, 2012).

3.7.2 Germany

The primary source of capital for companies is traditionally from bank loans. Unlike in the UK for example, their capital primary comes from capital markets. The internationalization of the German economy and the rising integration of the world’s capital markets have affected their accounting. The accounting system has had a significant influence on the accounting system in other countries, such as Japan, Austria and Sweden. Auditing dominates the financial reporting compared to accounting. Stock corporations and other large companies must be audited by a certified auditor, which is called Wirtschaftsprüfer (WP). Wirtschaftsprüferkammer (WPK) is an independent organization that is responsible for the auditing profession and itself is supervised by the state. WPK is also responsible for its members and the representation to other parties. The public accountants are mandatory to be a member of WPK. The Institute der Wirtschaftsprüfer (IDW) is a private association of public auditors and public audit firms who handles the education and continuing professional development. IDW’s main task is to publish statement on accounting and auditing questions, and these statements usually
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serve as generally accepted accounting and auditing standards. Germany’s auditing profession is more independent than its counterpart in China (Doupnik & Perera, 2012).

Commercial law, tax law and pronouncements from the profession affect financial reporting. The Commercial Code publishes most of the financial reporting principles. It includes the general accounting and auditing rules applicable to all companies. In addition, there is a special section relating to stock enterprises, and limited liability companies. Recently, the EU directives have influenced the accounting regulation in Germany. In May 1998, the German Accounting Standards (GASC) was created. GASC develops the accounting standards for consolidated financial reporting, represents Germans interest in international fora, and is responsible for advising the Ministry of Justice on the development of accounting legislation. In 2004, a new legal code for financial reporting was created, which is called the Financial Reporting Enforcement Panel (FREP) (Doupnik & Perera, 2012).

The financial reporting obligations are mostly based on the Commercial Code. Since 2005, all listed companies in Germany have to use IFRS in their consolidated financial statements. But IFRS has to comply with the EU directives. Globalization has had a large effect on the financial reporting. Parent companies that are publicly traded can also prepare their consolidated financial statements with other internationally accepted accounting standards, like US GAAP. German accounting practices and IFRS differ in some areas, mostly because German accounting law has no rules in some areas, and some areas differ from IFRS (Doupnik & Perera, 2012).

3.7.3 Japan

Before the World War II, the economy was dominated by zaibatsu, which were family-owned corporations. A bank was usually the source of capital. The Anti-Monopoly Law of 1947 dissolved the Zaibatsu during the post-war occupation. When the allied forces left Japan in 1952, the old formation reappeared under the name Keiretsu. In Japan, the main source of capital is bank credit or cross-corporate ownership. Where the finance is from, affects the financial reporting and attitudes of interested parties affects the need of financial information. Because banks are the largest source of capital and have access to their client’s information, there is relatively low level of information disclosure in the annual report. But in the 1990s, Japanese companies had to raise capital from other foreign sources, which also had an impact on the accounting (Doupnik & Perera, 2012).

The Certified Public Accountants law established the Japanese Institute of Certified Public Accountants (JICPA). JICPA is one of the members of IASC, and has been involved in the international harmonization process in Japan. Accountants, who are members of the accountancy profession, have the title CPA and practice under CPA law (Doupnik & Perera, 2012).

There are three laws that regulate the accounting and financial reporting; the Commercial Code, the Securities and Exchange Law and the Corporate Income Tax Law. Unlike other countries such as the US, tax law heavily influences Japan. It is a country with strong traditions, these traditions in accounting regulation differs from the approach in Anglo-American countries. The globalization has had a major effect on accounting and financial reporting in Japan, and it will probably continue to do so in the future (Doupnik & Perera, 2012).

In the current situation efforts, are being made to harmonize accounting principles closer to international standards. There are several differences between Japanese
accounting and IFRS, mainly because Japanese accounting does not have any rules in some areas, and also because there are inconsistencies between Japanese accounting and IFRS (Doupnik & Perera, 2012).

3.7.4 Mexico

About two decades ago, the government controlled a significant percentage of the business in Mexico, and a considerable amount was government owned. To accelerate a long-term economic growth, Mexico has designed a new economic program where effort has been made to privatize the state-owned companies. In the past, the most common ownership structure was family-owned corporations. An inflow of foreign finance and a return of finance invested in other countries in the 1980s and 1990s made an impact and stimulated the growth on Mexican stock market (Doupnik & Perera, 2012).

The Asociacion de Contadores Publicos was the first professional organization of public accountants, and it was established in 1917. Later, the Mexican Institute of Public Accountants (MIPA) exchanged this organization in 1964. Recently, MIPA’s Code of Ethics for professional accountants was revised towards IFAC’s code. It involves adoption of a framework, a principle approach and directions for implementation of the principles (Doupnik & Perera, 2012).

The legal system is based on civil law, but the accounting standard setting has an Anglo-American approach. MIPA is the normative organization in Mexico. There are different organizations that develop standards for accounting and auditing. The Auditing Standard and Procedures Commission develop auditing standards and the Accounting Principle Commission develops accounting standards (Doupnik & Perera, 2012).

Recently, the accounting has been influenced by the US accounting because of their membership in the North American Free Trade Agreement (NAFTA), also because MIPA is one of the founding members of ISAC and has an interest in international harmonization on the accounting standards. Today, the Mexican and the US accounting is generally the same. In some areas Mexico does not have any regulation, and then it is common for corporations to use the US regulation. In recent years, Mexico has started to convergence with IFRS. Starting in 2012, it will be mandatory for all companies listed on the Mexican stock exchange market to use IFRS (Doupnik & Perera, 2012).

3.7.5 The UK

The capital market is the main source of finance for companies. Accounting has developed into an independent discipline, responding to business needs. The UK accounting has influenced on the development of the accounting profession in many other countries. In 1853, the first professional accounting body was established; Society of Accountants in Edinburgh, that can be regarded as the beginning of modern accounting profession. In the UK, the Auditing Practices Board (APB) issues auditing standards (Doupnik & Perera, 2012).

There are six professional organizations; the Institute of Chartered Accountants in England and Wales (ICAEW), the Association of Chartered Certified Accountants (ACCA), the Chartered Institute of Management Accountants (CIMA), the Institute of Chartered Accountants in Scotland (ICAS), the Chartered Institute of Public Finance and Accountancy (CIPFA), and the Institute of Chartered Accountants in Ireland (ICAI).
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cooperation between these six organizations is coordinated through Consultative Committee of Accountancy bodies (CCAB) (Doupnik & Perera, 2012).

Accounting has traditionally a principles-based approach. A tradition is also that accounting principles and standards should be left in the hands of the profession. Recently, the Financial Reporting Council (FRC) has become an independent regulator. The membership in EU has had a significant effect on the UK accounting regulation by the EU directives, which has to be followed. Now FRC is an independent accounting and auditing regulator (Doupnik & Perera, 2012).

Since 2005 all listed companies in the UK must use IFRS when preparing their financial statements. Generally, the UK standards are similar to IFRS, because international standards have been influenced by the UK accounting. But still there are some differences between the standards (Doupnik & Perera, 2012).

3.7.6 Sweden

Between the years 2006-2008, the number of auditors doubled, and in 2008 there were about four thousands auditors (SOU 2008:32). The number of firms that offers auditing is about a hundred (SOU 2008:32), but in Europe you often talk about “The Big Four”, which is the four major firms offering auditing. “The Big Four” refers to PwC, Ernst & Young, KPMG and Deloitte (SvD, 2012a), who has more than 90 % of the market shares (Bäckström & Brännström, 2010). In Europe these companies’ market shares are 70 %, and in London they are auditing 99 % of the listed companies. This has recently been in focus as a problem, in not just Sweden, but also in Europe. The center of this question is how the independence is affected when there are just four auditing firms controlling the whole market. To discuss this problem further, a discussion paper has been presented. This discussion paper gives several possible solutions to the problem. One of them is to force companies to switch auditor after a certain period of time. Another solution is to set a limit on the auditor’s emolument per client (SvD, 2012b). This subject is discussed later in this chapter.

In Sweden, the mandatory for auditing was removed the first of November 2010 for the smallest companies (Swedbanks nyhetsbrev, 2010), as a result of an EU directive. Sweden is part of the EU, who are affecting the accounting and auditing. Most of the countries within EU had removed the mandatory auditing for the smallest countries before Sweden did (SOU 2008:32). The legislative change is a result of a requirement by the European Council, with the goal of reducing the costs for the smallest countries. The purpose was also to strengthen the European economy and to make the companies more competitive, by reducing their costs (SOU 2008:32)

As a result of Sweden being a part of the EU, they are following directives and recommendations by the EU regarding accounting and auditing (Revisorsnämnden), which also applies the adoption of IFRS for the consolidation (IFRS-volymen, 2010). The state authority is called Revisorsnämnden (“The Auditor Committee”) and is responsible for the certification of auditors and to oversight the auditors work. This committee, the certification of auditors and other matters regarding auditing is regulated by law (Revisorsnämnden).

In Sweden, the legislation works as a framework regarding the accounting. Therefore, there are complementary standard setting bodies. The biggest, which role is to interpret the law, is Bokföringsnämnden (Thorell, 2008). In recent years, the power of this organization has grown, and some say that the organization has more power than just to
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interpret the law. Instead of just interpret the law, Bokföringsnämnden are setting the standards which companies are obligated to follow (Thorell, 2006). As the power increases for this organization, the power of praxis by the companies has decreased significantly (Olsson, 2010).

When talking about the accounting and auditing profession in Sweden, a subject that is in focus is the “K-projects”. As already mentioned, listed companies has to prepare their consolidation in accordance with IFRS. Other companies are following Bokföringsnämndens recommendations, which are now divided in to different regulations. “K3” should be follow by the biggest unlisted companies, and this regulation was approved in June 2012. Parent companies that are unlisted can chose to follow IFRS in their consolidation if they want to. The regulations “K1” and “K2” contain simplifications, and are suitable for smaller companies (BFN, 2012a). K3 is based on International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs), but is changed to fit with Swedish rules for accounting and tax, and also praxis (BFN, 2012b). A lot of time and effort had been spent on the project, and the set of standards are supposed to heighten the quality in the accounting, as well as be more like IFRS (Abrahamsson et. al, 2011).

3.7.7 Summary of the Professionalism in Different Countries

Here is a summary of the professionalism in the countries that are compared in this chapter.

<table>
<thead>
<tr>
<th>Country</th>
<th>Summary of the professionalism</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Professional accounting and auditing firms has a connection with some government organizations. Non-skilled profession in the past. Ministry of Finance regulates accounting and auditing.</td>
</tr>
<tr>
<td>Germany</td>
<td>Primarily source of capital is bank loans. The Institute der Wirtschaftsprüfer regulates accounting and auditing. Tax law affects financial reporting.</td>
</tr>
<tr>
<td>Japan</td>
<td>Main source of capital is bank loans and cross-corporate ownership. Influenced by tax law. Strong traditions are affecting the accounting and auditing, but major efforts are being made to harmonize this areas into the international approach.</td>
</tr>
<tr>
<td>Mexico</td>
<td>In the past, mostly family owned companies. Based on civil law. The Auditing Standard and Procedures Commission develop auditing standards and the Accounting Principle Commission develops accounting standards</td>
</tr>
<tr>
<td>The UK</td>
<td>Capital market is the main source of capital. Accounting principles and standards should be left in the hands of the profession. The Financial Reporting Council is the regulator.</td>
</tr>
<tr>
<td>Sweden</td>
<td>Law regulates auditing. The legislation works as a framework regarding the accounting. K-projects.</td>
</tr>
</tbody>
</table>

Figure 3.10 Summary of profession.
3.8 Criminal- and Civil Penalties

An important aspect is how different sanctions affect auditors in their work. What happens if the accountant or auditor makes accounting errors (Olsson, 2010)? An auditor can generally be subject to three kinds of liability. One is civil liability, which means that the auditor breaks contractual or civil obligations or both. Another liability is criminal liability, and it means that the auditor engages in criminal activities such as providing misleading information intentionally. The third liability, professional liability, is when an auditor violates the rules of the professional bodies it belongs to. In some countries the auditor is liable to third parties (Doupnik & Perera, 2012). The auditors usually have professional indemnity insurance, and it primarily covers the professional liability (European Union, 2012). It is easy to argue that penalties should exist, because otherwise the norm would be unnecessary if devotions from it do not justify sanctions (Olsson, 2010).

Recently in China, the legislator has proposed a new law change. This means that accountants can face criminal penalty in the event of accounting fraud. This could be if their report misses a declaration that the financial statements is in agreement with the auditors accounting records, or if the auditors failed to declare that they did not have all the information needed for the audit. The government believes that this law change is a significant step for increasing the reliability of financial statements and improves the regulatory for auditors. But the accounting industry and Hong Kong Institute of Certified Public Accountants (HKICPA) mean this proposal is too harsh. They want the legislators to scrap the criminal liability clause (SCMP, 2012).

The professional body WPK in Germany is the organization that gives sanctions to auditors. The sanctions can be warnings, fines up to 50.000 euro and the WPK can also give a temporary suspension or exclude the member from the profession (Worldbank A, 2012).

In Japan, like in China, the government wants harder penalties to be introduced for auditors. The government means that harder penalties would send shivers through the professional industry and that would deter auditors from making errors (Reuters, 2012).

Instituto Mexicano de Contadores Publicos (IMCP) is the organization in Mexico who is responsible for imposing sanctions. But there is no legal provision that indicates the statutory auditor’s liability. Therefore, there is an environment of unconcern against risk of malpractice to auditors who do not have professional indemnity insurance. To be able to sue an auditor, the complaint has to demonstrate, beside the damages they suffered from, a serious professional miscondu ct or conscious misconduct (Worldbank B, 2012).

In the UK, the regulator has proposed larger fines for misbehaving audit firms. The Accountancy and Actuarial Discipline Board (AADB) believe that harder penalties need to be introduced to deter auditors from making errors. AADB believe that if auditors face harder penalties they will be more cautious in their assessments. One reason for AADB proposal is that the profession has become concentrated of four big audit firms (Financial times, 2012). Today, AADB can give sanctions like warnings, fines, exclusion of membership and a withdrawn practicing license (Worldbank A, 2012).

In Sweden, to be able to give sanctions, the act needs to meet the main criterion. The main criterion means that the act needs to affect someone; it is not enough to deviate from law and norms. An example is if the accounting records are wrong that affect for instance creditors, shareholders and the general public because the company’s financial
position in the accounting records is wrong. The act can then provide a civil penalty (Olsson, 2010).

3.9 Summary

So far this chapter has presented and discussed differences in auditing between the six countries that are in focus for this comparison. First, the organization which are in interest of this chapter was presented; IFAC, IAASB and ISA. Secondly, the factors that are influencing the accounting to become different between countries were presented and the connection towards auditing was discussed. The legal system and the providers of finance are affecting the auditors’ work, and there are a diversity in auditing between countries because of these factors. There are issues concerning the auditing diversity, and IFAC are striving for auditing harmonization in the world. The success so far has been limited. (2012).

The differences between counties regarding education, culture and professionalism are presented in the table below.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Education</th>
<th>Culture</th>
<th>Professionalism</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Not well developed. Do not follow IFAC recommendations; only courses in accounting and auditing (no general business knowledge).</td>
<td>High power distance, collectivism, masculinity, low uncertainty avoidance and a focus on long-term orientation.</td>
<td>Professional accounting and auditing firms has a connection with some government organizations. Non-skilled profession in the past. Ministry of Finance regulates accounting and auditing.</td>
</tr>
<tr>
<td>Germany</td>
<td>University degree are required and also four years of practical experience.</td>
<td>Low power distance, individualism, masculinity, high uncertainty avoidance and a focus on short-term orientation.</td>
<td>Primarily source of capital is bank loans. The Institute der Wirtschaftsprüfer regulates accounting and auditing. Tax law affects financial reporting.</td>
</tr>
<tr>
<td>Japan</td>
<td>The requirements are high. Few passed the exam before. Both theoretical knowledge and two years of practical experience are required.</td>
<td>Medium high power distance, medium individualism, masculinity, high uncertainty avoidance and a focus on long-term orientation.</td>
<td>Main source of capital is bank loans and cross-corporate ownership. Influenced by tax law. Strong traditions are affecting the accounting and auditing, but major efforts are being made to harmonize this areas into the international approach.</td>
</tr>
<tr>
<td>Mexico</td>
<td>A professional diploma is required. The CPA can perform auditing in the US and Canada because of an agreement between these countries.</td>
<td>High power distance collectivism, masculinity and high uncertainty avoidance.</td>
<td>In the past, mostly family owned companies. Based on civil law. The Auditing Standard and Procedures Commission develop auditing standards and the Accounting Principle Commission develops accounting standards.</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th>The UK</th>
<th>Low power distance, individualism, masculinity, low uncertainty avoidance and a focus on short-term orientation.</th>
<th>Capital market is the main source of capital. Accounting principles and standards should be left in the hands of the profession. The Financial Reporting Council is the regulator.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>Low power distance, individualism, femininity, low uncertainty avoidance and a focus on short-term orientation.</td>
<td>Law regulates auditing. The legislation works as a framework regarding the accounting. K-projects.</td>
</tr>
<tr>
<td>Two types of auditors. The CPA is required to have a university degree (four years) and five years of practical experience.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 3.11 Summary.

The criminal- and civil penalties concerning auditing were presented, and the sanctions for errors in the accounting and auditing are different between the compared countries. There are also differences in the debate on whether the penalties and sanction should become more stringent.

3.10 Discussion

This part of the chapter is organized after the questions asked in the beginning, to give a broader view of the auditing and the auditor in the specific country. It is important to see the differences between countries in these aspects and that is why each question is answered individually.

3.10.1 The Independence of the Auditor

In China, the legislator wants to increase the penalties for auditors, if the auditors risk losing their independence, which is an important requirement. Then maybe it is not wrong to increase the penalties. But it can be discussed how much the penalties should increase. China has high power distance and is collectivistic, which could affect the auditor’s independence. This might lead to unwillingness to question financial statements from powerful clients; they respect their leaders and it is not right to question them. In the past, companies were state-owned. That changed but still many companies have a connection with some government organization. That could also affect the independence of an auditor. Since Japan also is a collectivistic country, auditors might see to the company’s best, not what is right seen from an auditor’s point of view. If that would happen, the auditor is not independent.

In Germany, the accounting and auditing is well developed. Their accounting has even affected accounting in other countries, such as Japan and Sweden. The culture is characterized by individualism, and it can be assumed that this also applies to auditing. If auditors think about themselves, that can mean that the auditor do not care about what company or which people who sit on the board on the company they revises. That can lead to that the auditor is independent towards the company, unlike the auditors in China.
The auditor rather wants to be honest than risk sanctions. Germans believe in being honest even if it hurts. Independence, as we mentioned before, is an important requirement. Investors are more likely to trust the financial statements if the auditor is independent.

In Japan, a country that is collectivistic in some ways, they do not trust people from the outside. This could be a problem for an auditor who wants to be independent. It might seem more important to be part of the group they are auditing than questioning the financial reports. Some people in Japan mean that harder penalties would deter auditors from making errors and if Japan wants to minimize the risk for non-independent auditors, harder penalties could be a solution. It seems quite logical that harder penalties would make it much less attractive to make errors in auditing.

In Mexico, which is a high power distance culture, auditors may be less willing to, for example, question financial results developed by powerful clients or give in to pressure from them, like in China. As a result of these actions, the behavior of an auditor becomes the opposite of independent.

The profession of auditing is strong in the UK, and there are six professional organizations. The people are highly success oriented and driven, which is explained by the culture and high score of masculinity. Four of the organizations are responsible for examinations of CPAs. In many countries the examinations are closely restricted to the law, but not in the UK. This is a god example of the strong profession and independence towards the legal system. Because of the culture of masculinity and individualism, there is an expectation on the auditor to be performing the auditing independent and with professional skepticism.

In Sweden it is important to be independent. This should also apply to auditors, a will to be independent and question accounting errors. Ekenstam and Flink (2011) write about that it is customary practice for auditors to speak to the shareholders on general meetings is another example why Swedish auditors should be independent. A non-independent auditor should probably get caught quite fast if they are not doing their job independently.

3.10.2 Auditing and Penalties

As mentioned earlier “The Big Four” has large market shares on the auditing market in Europe, about 70 %. In Sweden and the UK that number is even higher. This is seen as a problem by the governments, and it is up for discussion on how to solve the situation. In the UK the government wants to heighten the fines for misbehaving in auditing. As discussed earlier, in Sweden there is not as much sanctions compared with other countries. Instead of higher fines to solve this problem, other options are discussed; such as force companies to switch auditing firm at a certain period of time. How the countries, or the EU, decide to do is of course affecting the auditors. The governments in China and Japan are also considering increasing the penalties for errors made by auditors. Different approaches concerning penalties against auditors would slow down the harmonization process. If auditing errors concerning the same thing give different penalties in different countries, it might be more possible that certain criminal activities are being performed in countries with not as harsh penalties. This would in turn lead to clear differences in the auditor’s work between countries with less harsh and harsh penalties.

Recently in China, the legislator has proposed a new law change, as mentioned before. This means that accountants can face criminal penalty in the event of accounting
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fraud. The government believes that this law change is a significant step for increasing the reliability of financial statements and improves the regulatory for auditors. Since China is a country with high power distance, it might seem as a good idea to make penalties are bit harder. In countries with high power distance, auditors might not want to question powerful clients or they might give in to pressure from them. Harder penalties for misconduct of an audit are possibly a good idea to make it less appealing.

The legal system in Germany is code law, which affects the financial reporting. Code law do not give precise rules, one also have to seek in other laws and recommendations from organizations. An auditor has to rely on the accounting law in a higher degree. That can contribute to why Germany has become a part of the harmonization, because they have to seek in international rules and recommendations. It could seem almost natural for them to be part of the harmonization process due to this. Since penalties can be quite hard in Germany (excluded from the profession) and a country with relatively low power distance, auditing misconduct does not seem so likely and common in Germany. Also, since they have code law they have to seek in other laws and recommendations as already mentioned, so it might not seem unlikely that they follow ISA and perform their audit accordingly.

In Japan, like in China, the government wants harder penalties to be introduced for auditors. The government means that harder penalties would send shivers through the professional industry and that would deter auditors from making errors. In Japan, people do not generally trust outsiders, as mentioned before. An outsider here is an auditor and they might feel forced to give in to certain pressure from the company to get access to information and in return the auditor will overlook possible accounting errors. Harder penalties should, as mentioned before, make it less appealing to commit auditing misconduct.

Mexico is also a country where they have clear rules, and in auditing this means that there is less room for their own professional judgment in uncertain situations. However, when it comes to penalties regarding auditing misconduct one have to be able to demonstrate that the damages that has been done is from a serious professional misconduct or conscious misconduct. It seems harder to convict an auditor for misconduct in Mexico than other countries because it might not be easy to always show that the damages are from actions relating to the auditors work. Mexico is also a country with high power distance, which could lead to, as in China, that auditors are unwilling to question a client’s accounting error if it is a powerful client. This, together with the seemingly hard ways to get an auditor convicted for auditing misconduct, leads to a concern of harder penalties for Mexico to prevent auditing errors. It seems quite likely that auditing errors exists in Mexico based on how their country looks, with the low possibility of getting auditors convicted for misconduct.

The fact that accounting rules are set by the professional in the UK, and not by law, can be explained by the legal system. In most of the English-speaking countries, the UKs legal system is based on common law. The legal system has an impact on the auditors work, because he or she has to search for guidance in rules set by the profession itself. The strong profession can therefore be explained by the existing legal system. In the UK, there is a proposal for harder penalties because they believe it could deter auditors from making errors, which seems like reasonable argument.

Concerning the structure of accounting rules, Sweden has been influenced by Germany; probably because of economic ties resulting from trading between the countries. As in Germany, Sweden also has a strong connection between accounting rules
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and tax system. Germany’s legal system is explained as a code law, which is as likely the case in Sweden too. This assumption is mainly made based on the fact that the accounting rules in law can be seen as a framework with complementary standard setting bodies, and the strong connection towards tax system. The auditor in countries with code law has to take the law into account in a higher degree, as we have already mentioned. The new K-projects are a good example of how the accounting is adopted for tax rules. K3 is built on IFRS for SMEs, but has been adopted for accounting - and tax rules.

In the part about culture, the reader learned that in Sweden, people have a relaxed attitude towards rules; people do not want rules if it is not absolutely necessary. That can be a reason why Sweden’s legal system works as a framework, concerning the accounting rules. This will also explain the gentle approach to sanctions when the accounting is wrongly conducted. In several countries that have been compared in this chapter, errors in the accounting have been suggested to lead to stricter punishments. However, this is not the case in Sweden, which can be explained by the culture and the low scores in uncertainty avoidance.

3.10.3 Harmonization

Much has been done to harmonize the auditing, but the comparison of the selected countries shows that there is much work left. It is a problem. If the same standard for accounting and auditing were used all around the world, many problems would disappear. On the other hand, if the same standard were used, different cultures would probably still mean that auditors from two different countries would evaluate one financial statement differently. That is a problem difficult to avoid, because every countries’ culture and traditions are different. If the same standard were used, investors would know at the starting point for the analysis of financial statements is the same for auditors. That can smooth the progress of the comparison between different companies. Harmonization is the internationally goal and if everyone used the same standard that would be a big step forward.

EU is an example that has started to harmonize between their member countries by their directive. Germany, the UK and Sweden are members in EU. Therefore these countries are affected by the directives and are therefore required to follow ISA. This explains why these countries are more alike, concerning education for example.

As presented in the beginning of this chapter, IFAC are striving for harmonization in accounting and auditing in the world. ISA is an important step in this direction, and it would be a big step in this direction is the whole world was following ISA.

3.10.4 The Importance of the Harmonization of Profession

The comparison between the six chosen countries shows that there are differences in the profession. As mentioned before, differences should be as small as possible when it is about auditing for many reasons. Many aspects affect the profession of auditing and the optimal would be that all aspects is as similar as possible. But that is not the reality. History, legal system and capital source are some subjects that affect which differs between countries. If the capital is primarily from shareholders, the financial statements are more detailed and the auditing is then more precise and developed. If the auditing is more develop that is also the case for the profession. Who sets the accounting rules in a
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country, also affects the profession. These are some subjects that differ between the studied countries and which can affect the profession in a country.

The UK is a country with well-developed profession, and the accounting has also affected other countries profession. Because the profession is well developed, the UK can be seen as a role model for other countries. This is because the UK already has affected the profession in other countries.

Harmonization of the profession would mean that fewer subjects could affect the auditor, and fewer difficulties would exist in their work. But many things affect the profession that is hard to change, like history in a country.

3.10.5 The Importance of the Harmonization of Education

Education is an important part of the harmonization of auditing. For auditors the education is an important foundation for their future in the profession. Education is another example that differs between the studied countries. If the education would be the same, investors would know that all auditors around the world have a good foundation through their education. That could make investors feel safer and that they can trust the audited financial statements in a larger degree than today.

In China, the auditors risk to not have all the knowledge they need when they only contain courses within auditing and accounting. Then it can be difficult for auditors to follow international rules and recommendations when they do not have general business knowledge.

Germany’s society is characterized by masculinity, which value high performance. This can be seen in the education for auditors. First they must have a university degree, then four years in practice which two years are in audit before being an auditor. If one compares this to China, auditors have a much broader foundation in Germany than in China. It is more likely that auditors in Germany can interpret international rules. Investors will also know that they have broader business knowledge.

Japan still has high requirements to become a CPA, which might have to do with the fact that Japan puts the groups best before individuals; they do not trust outsiders. People might trust auditors more if they know that the auditor has gone through a tough and demanding education. Another thing that could be an issue for the auditor here could be that the auditor oversees possible accounting errors just to gain more trust from those who are being audited. However, the high requirements in education might be good considering IFACs recommendations about broader general business knowledge.

To become an auditor in Mexico one is obligated to have a professional diploma. In UK, the auditors have to study relevant courses, practical experience and pass the final exam. Then investors know that auditors who has audit the financial statement is someone with a broad business knowledge and they can then trust the statements in a greater extent.

What particularly is special with the education to become an auditor in Sweden is that there are two types of auditors; CPA and the “approved public accountant”, for who the requirements are lower, compared to become a CPA. This system is unique for Sweden.

Germany, UK, Japan and Sweden are the countries with the highest requirements in the education. An auditor in these countries has broad business knowledge, like IFACs recommendation. The financial statements should therefore be trustworthy for the investor. It is probably more likely that investor choose to invest in companies in these countries, because the risk of errors in the financial statements is smaller.
3.11 Conclusion

The type of culture in the specific country affects the auditor’s independence. Different cultures can lead to different approaches to clients. This will probably lead to a difference in independence between auditors in different countries. As a result of this, the auditing is performed differently between countries. This can be seen in the difference of auditor independence in for example Mexico and Germany. Auditors in Mexico might not want to question powerful clients compared to Germany where they probably will be more honest than risk sanctions.

Many countries want harder penalties for misconduct but not Sweden. Most countries believes that harder penalties will result in less auditing errors which is probably the case since harder penalties will make auditing errors less appealing and more risky.

There are still large differences in auditing between countries despite the work towards harmonization. The least differences seem to be between countries in the EU, which depends on the EU directives that says that all EU countries should follow ISA. If more companies and countries were to follow ISA, the differences would decrease. Meanwhile, there are differences in culture and the influence of the profession and history, which means that a completely unified auditing profession is highly unlikely. Things that affect auditing, also affects the profession. Differences can make it harder for auditors in their work and a harmonization would be wishful but many things affect the profession.

A step towards a more unified auditing profession between countries would also be a more equivalent education. Nowadays accounting students all over the world read different courses for a different amount of time and the time spent on practical experience varies as well before they become a CPA. If everyone with the title CPA would have an equivalent education, the auditing diversity would most likely decrease.

3.12 Questions

- What is IFAC working for to develop, and how is the work important?
- What is ISA?
- How is the education in Sweden different from the other compared countries?
- What is special about Japan’s culture?
- Should you refer to the UKs profession as strong or weak?
- What are the differences between Mexico’s and Sweden’s penalties?
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Section 3
Consolidated accounts
4.1 Introduction

In the wake of the latest financial crisis questions arose regarding transparency and the hidden risks investors were subject to when investing in companies utilizing off-balance sheet vehicles (Effect analysis – IFRS 10 & 12, IFRS, 2012). The possibility to hide liabilities off-balance sheet is not in accordance with the fundamental idea of transparency and the basic thought that the financial statements of an entity shall provide a true and fair view of its finances. Previous standards regarding consolidation of financial statements provided limited disclosure requirements in subsidiaries and no requirements at all in unconsolidated structured entities, meaning entities structured in a way where voting rights are not the main factor when determining control (Ibid, page 11). IFRS 10 aims to clarify the definition of control and define when an entity should or should not be consolidated.

The previous standards, IAS 27 and SIC 12, had separate objectives. IAS 27, which was the main standard, emphasized the concept of control whereas SIC 12 was meant as a complement and focused on risks and benefits. This irregularity resulted in practical inconsistencies in the application of the standards alongside the fact that some reporting entities even found it difficult to decide whether to use IAS 27 or SIC 12 in regards to specific investees.

Control is the essence of IFRS 10 and many questions arise when you try to define and apply it. The amalgamation of the concepts in IAS 27 and SIC 12 aims to clarify certain areas where uncertainty, due to a lack of application guidance regarding the existence of control in non-majority cases, previously prevailed (Effect analysis, page 8, IFRS, 2012). This chapter will try to explain the differences in the definition of control between the old standards IAS 27 and SIC 12 and the new IFRS 10.

To summarize, the questions to be answered in this chapter are:

- How is the concept of control explained by IFRS 10 and how does it differ from the old definition given by IAS 27 and SIC 12?
4.2 Disposition

This chapter starts out by describing IAS 27 and SIC 12, the predecessors of IFRS 10. It will provide the reader with knowledge regarding the cornerstones of the old standards in order to more easily comprehend the changes and additions made in IFRS 10. The second part of the chapter describes IFRS 10 along with its new concepts and definitions. The last part is an analysis focused on the effects of the implementation of IFRS 10 and what these effects could imply for reporting entities regarding consolidation of financial statements.

4.2.1 Definitions

- Special purpose entity – A legal entity created to fulfill a specific objective. Typically used by companies to isolate risk regarding a specific project or asset.
- Structured entities – A term used in IFRS 10 closely related to the above mentioned special purpose entity and commonly designed in a way where decision-making rights are prescribed through contractual agreements.
- Bright lines – Bright line rules, commonly referred to as bright lines, is a clearly defined rule or standard. In accounting it could be called the opposite of principles-based accounting.

4.3 Currently used standards

The standards currently applied when consolidating financial statements are IAS 27 (Consolidated and Separate Financial Statements) and SIC 12. The following paragraphs will provide an insight into how they are structured and their main features.

4.3.1 IAS 27

The objective of IAS 27 is to give guidance how to prepare and present a consolidated financial statement for a group of entities under the control of a parent company (IAS 27, 2011). A consolidated financial statement shall include all subsidiaries of the parent company and has been applied since the 1st of January 2005 and will be replaced by IFRS 10 in 2013.

For a parent company to be seen as having control over an entity they need to have, either directly or indirectly through subsidiaries, more than half the voting power of an entity. The exception is, in rare cases, where it cannot be shown that the parent company has control through such ownership (IAS 27, 2011).

In a case where the parent company owns less than half of the voting rights of an entity control exists if:

- How will IFRS 10 and its new criteria’s regarding an investors control over an investee improve the disclosures of consolidated financial statements?
Consolidation of financial statements

- The parent company got half of the voting rights through an agreement with other investors.
- The parent company has the power to govern the entity's operating policies through statutes and agreements.
- The power to appoint or remove the majority of the entity's board or directors belongs to the parent company.
- The parent company got the rights to cast the majority of the votes at the meetings of the governing body of the entity.

An entity may for example also own share call options, share warrants and debt and equity instruments which could be converted into ordinary shares. If these shares are exercised or converted, they have the potential to give an entity voting power or reduce another party's voting power. The effect of the potential voting rights is considered when determining whether an entity has the power to control the financial and operating tactics of another entity. When evaluating if these potential voting rights brings control to the entity they need to examine all facts and circumstances that regards the potential voting rights (IAS 27, 2011). To take into consideration is that regardless if the absolute or relative ownership levels change or not, a parent company can lose control of a subsidiary. Examples of that scenario are if the control of a subsidiary is taken over by a government, court or regulator. It can also take place due to a contractual agreement (IAS 27, 2011).

4.3.2 SIC 12

Standard Interpretations Committee consists of 14 voting members from different countries and professional backgrounds. The key feature of their work is to reach a consensus on the appropriate accounting treatment and to offer authoritative guidance on the given issue that rise up from the current international reporting standards. SIC work very closely to national committees in developing interpretations, which are subject to IASB approval and enjoy the same power as a standard developed by the IASB if approved. The interpretations cover both:

- Newly identified financial reporting issues not specifically dealt with in IFRSs; and
- Issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance (IFRS 10, 2012).

SIC 12 was issued in November 1998 and put in effect for financial periods beginning on and after January 1999. The standard clarifies when a special purpose entity (SPE) should be consolidated by a reporting enterprise under the principles in IAS 27. SIC 12 states that an entity has to consolidate a SPE when they meet certain requirements for control and when the economic meaning of the business relationship suggests that it is in control of the SPE. An entity is in control over an SPE when, for instance, the SPE is driven in a predetermined way. An entity can also be in control over a SPE even though it does not own a part of the equity in the SPE.
Apart from the examples in IAS 27 SIC 12 mentions a couple circumstances when a company is considered to have control over a SPE (IAS, 2011):

- The business of the SPE is driven by most part by the entity’s need and with the intention to take advantage of the SPE,
- The entity has in practice the right to decide to obtain most of the benefits that the SPE is producing,
- The entity has the right to obtain most of the benefits connected with the SPE and therefore is exposed to the risks that is associated with the SPE, or
- The entity in practice stands for most parts of the risks that are associated with the ownership of a SPE and their assets in order to obtain the benefits that the business is generating.

4.4 Redefining control

IFRS 10 - Consolidated financial statements describes the preparation and presentation of financial statements when an entity controls one or more other entities. January 1st 2013 IFRS 10 takes effect and thereby supersedes its predecessors, IAS 27 and SIC 12. (IFRS 10, 2012) As previously mentioned focus has shifted from “control through voting rights” (IAS 27, 2011) and “risks and benefits” (SIC 12, 2011) towards one of the main reasons IFRS was created, a common definition of control. The definition of control itself has not changed, but the measurement of control has been clarified. (Effect analysis, page 16, IFRS, 2012) Issues previously only implicitly required, such as the possibility of control without majority and continuous assessments of control, are now explicitly required and included in the application guidance (Ibid). A reporting entity in control of an investee is required to consolidate that investee and with IFRS 10 comes the ability to apply the same control model to all investees (Ibid, page 8). Control, according to IFRS, consists of three elements: power, exposure to variable returns and the ability to affect the amount of returns receivable (IFRS 10, 2012). The main difference between IAS 27/SIC 12 and IFRS 10 regarding control is the application guidance and the extent to which the concept of control is described IFRS 10 requires an entity that is a parent to prepare and present consolidated financial statements. Reporting entities using IFRS standards are required to use the concept of control when determining whether to consolidate an investee or not. (Effect analysis, page 8, IFRS, 2012)
An investor is in control of an investee when the investor is exposed to the risks of variable returns stemming from the investee and at the same time is able to affect the size of these returns through its power over the investee (IFRS 10, 2012). These three elements constitute the basis of the single control model, the backbone of assessing control and thereby also the backbone of IFRS 10. The implementation of IFRS 10 and one single control model means that this single control model needs to have a broader view of the control concept regarding which activities of the investee that effects the return of the investor, and which of these activities that could lead to consolidation. (EFRAG, 2012)

When determining whether control over an investee exists or not, it might be helpful to make the following considerations in addition to the three aforementioned elements of control (IFRS 10, 2012). For an investee created with a special purpose, the investor first of all need to assess the purpose and design of the investee in question. The investor will then need to identify the investee’s activities affecting return and who is in control of these activities. Furthermore the investor will need to assess if it is exposed to the variable returns of the investee and if the power it wields over the investee can affect decisions regarding the size of the variable returns, explicitly or implicitly (Balans, s. 45, nr 8-9, 2011).

4.4.1 Power over the investee

The key feature in deciding whether an investor has power over an investee is the right to decide about activities that is considered to be of significant nature for the investee regarding financial returns (IFRS 10, 2012). These relevant activities are defined as activities that significantly affect the entities returns and can exist even if those activities only occur under special circumstances (EFRAG, 2012). The relevant activities are either directed through voting rights such as shares or by contractual agreements. Most of the time assessing power is quite easy since it is determined by voting rights where the majority shareholders automatically has power, which means that no further assessment is needed (IFRS 10, 2012). But there are some cases where several factors come in to

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**Figure 4.1 The elements of control. (PwC, 2011)**

Power

- Control

  Ability to use power to direct variable returns

  - Power
  - Variable returns

Consolidation of financial statements
play, for example in situations where the relevant activities are directed through one or more contractual agreements. If two or more investors share an equal ability to direct different relevant activities, for example in a situation where one investor decide about the product development and the other over the manufacturing, the investor whose relevant activities most affect the investees return is seen as having power (IFRS 10, 2012). In order to conclude this IFRS has a lot of different activities that can be considered as relevant. This can be summarized in the following model:

<table>
<thead>
<tr>
<th>Relevant activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do both activities significantly affect investee’s return?</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>A) The purpose and design of the investee;</td>
</tr>
<tr>
<td>B) The factors that determine the profit margin, revenue and value of the investee as well as the value of the product.</td>
</tr>
<tr>
<td>C) The effect on the investee’s return resulting from each investor’s decision-making authority with respect to the factors of B; and</td>
</tr>
<tr>
<td>D) The investor’s exposure to variability of returns.</td>
</tr>
</tbody>
</table>

Consider only the activities that significantly affect investee’s return

Figure 4.2 Relevant activities directed by different parties. (PwC, 2011)

Another important feature when assessing power is what type of rights an investor has over an investee. There are substantive rights which basically mean that the investor has the ability to exercise their right, and there are protective rights which could be described as means to prohibit fundamental changes in the activities of an investee that the holder does not agree with (PwC, 2011). When an investor assesses whether it has power over an investee it only consider the substantive rights, something that implies that the holder of the right also have the ability to exercise it. This is something that enquires judgment, and the investor need to take fact and circumstances into the decision. IFRS 10 brings up a few of these circumstances, which are the following:
An investor with less than the majority of the voting rights can still be considered as having power over an investee when it, through its own voting rights alone, can direct the relevant activities of an investee. This is called de facto control. Holding the largest block of voting rights with the remaining voting rights widely dispersed might prove enough for an investor to direct the investee’s decisions and thereby be considered to be in de facto control (IFRS 10, 2012). In some cases holding the largest block might not be considered as enough to determine whether an investor is in de facto control or not. In these cases there are secondary considerations to take into account, such as precious voting patterns and rights to approve managerial staff with ability to direct relevant activities (IFRS 10, 2012).

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<table>
<thead>
<tr>
<th>Substantive rights</th>
</tr>
</thead>
</table>

---

## Consolidation of financial statements

### Is there practical ability to exercise?

<table>
<thead>
<tr>
<th>Are there barriers to exercise of those rights by holder?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example:</td>
</tr>
<tr>
<td>- Financial incentives or penalties;</td>
</tr>
<tr>
<td>- Exercise/conversion prices that prevent exercise/conversion;</td>
</tr>
<tr>
<td>- Inability to obtain information needed to exercise rights;</td>
</tr>
<tr>
<td>- Legal/regulatory requirements that prevent exercise.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Do practical mechanisms exist for collective exercise of rights?</th>
</tr>
</thead>
<tbody>
<tr>
<td>- The more parties that need to agree, the less likely that the right are substantive.</td>
</tr>
<tr>
<td>- Independent board of directors may provide the required mechanism.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Will the holder benefit from the exercise of those rights?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential voting rights are more likely to be substantive if;</td>
</tr>
<tr>
<td>- They are in the money or;</td>
</tr>
<tr>
<td>- The investor will benefit for other reasons from exercise( for example, realize synergies)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Is the right exercisable when decisions about the relevant decisions need to be made?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substantive rights</td>
</tr>
</tbody>
</table>

Figure 4.3 Flowchart for determining whether rights are substantive. (PwC, 2011)
4.4.2 Exposure, or rights, to variable returns

The second element when deciding if a parent company has control over an entity is the exposure or the rights to variable returns from its involvement with the investee (IFRS 10, 2012). Returns, with the potential to vary due to result of the performance of an investee and which not are fixed, counts as variable returns. These returns can be only positive, only negative or both. Remuneration for servicing the assets or liabilities of an investee, residual interests in the investee's assets or liabilities and dividends is examples of these returns. There are also returns that are not available for other interest holders, which also count as variable return. Examples of this is when a parent company use their assets in a combination with the investee's assets to create economies of scale, cost savings or to raise the value of the parent company's other assets. To determine if the return from the investee is variable the investor needs to assess how variable the return is on the basis of “the substance of the arrangement and regardless of the legal form of the returns” (IFRS 10, 2012).

4.4.3 The link between power and control

The third criteria in IFRS 10 § 7 that has to be fulfilled for an investor to have control over the investee is that the investor has the ability to use its power over the investee to affect the amount of the investor’s return. To assess whether a fund manager or asset manager who got decision-making rights actually controls the entity that it manages is not the easiest task under IAS 27 or SIC 12. Neither of them gives any specific guidance regarding situations where power is delegated to an agent and it has been unclear how to assess agency relationships within the context when determining control (IFRS, 2011). To determine control it is important to clarify and define the link between power and returns. The new IFRS presents two paragraphs that states the criteria’s that must be fulfilled for there to be a link between power and control and for an investor to have control. According to IFRS 10 (2012, p 17-18);

An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor’s returns from its involvement with the investee.

Thus, an investor with decision-making rights shall determine whether it is a principal or an agent. An investor that is an agent in accordance with paragraphs B58–B72 does not control an investee when it exercises decision-making rights delegated to it.

Paragraphs B58-72 in IFRS 10 addresses the question of when a decision-maker is an agent or a principal to determine whom the actual decision-maker is.

According to IFRS 10 an agent is a party who mainly operates on the behalf and for the benefits of another party or parties, which in this case is the principal. Because of that the agent does not have the control of an investee when it exercises its decision-making authority. However, an agent could hold and exercise the principal’s power but on behalf of the principal. Decision-making rights delegated to an agent from an investor should be treated as held by the investor directly when assessing whether it controls an entity. When determining whether a decision-maker is an agent the factors that should especially be taken into account according to IFRS 10 are:
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- The scope of its decision-making authority over the investee.
- The rights held by other parties.
- The remuneration to which it is entitled in accordance with the remuneration agreements.
- The decision-makers exposure to variability of returns from other interests that it holds in the investee.

The first two listed factors assess the extent of the decision-maker’s power over an investee and whether there are any restrictions bound to this power. For instance, an agreement could specify that the asset manager got the decision-making rights over relevant activities for an investee, but at the same time state that the asset manager could be removed at any time by a majority vote (PwC, 2011).

The last two factors covers the criteria’s of return from the investee. The asset manager should consider the variability and magnitude of the returns it gets from the investee compared to the total returns expected from the investee. One example is that the asset manager could have a limited exposure to the investee’s variable returns depending on the on-market management fees it receives (PwC, 2012). The management should analyze if these returns together with the asset manager’s power over the investee suggests that the manager should be considered as a principal.

In the assessment of control, the investors should also consider the nature of its relationship with other parties involved to decide whether another party is acting on behalf of the investor. If this is the case the parties in question could be considered to be a de facto agent, a party who is not contractually bound but in reality acts as an agent to the investor. This assessment can be highly judgmental and it requires consideration both of the nature of the relationship and the interaction between the investor and the parties in question (IFRS 10, 2012).

4.4.4 Structured entities

As previously stated, voting rights do not always provide an effect on the investee’s returns. In certain entities the direction of relevant activities is determined through contracts, and voting rights are merely administrative. These entities are portrayed as ‘structured entities’. (IFRS 10) Even though the contract may provide direction for what seems to be the relevant activities, the investor must still assess the contractual agreements to decide whether it provides the investor with indirect power over the investee through risks passed on from the investee (PwC, 2011).

Such rights as call rights, put rights and liquidation rights may be closely related to the investee’s purpose and relevant activities. If that is the case, the investor will need to take this into consideration when assessing power over the investee (IFRS 10, 2012). Even if this power arises only under certain circumstances, which may have not even occurred yet, the investor might still be considered as having power over the investee (IFRS 10, 2012).

An investee designed for a single purpose is commonly called a ‘special purpose entity’, from now on called SPE. SPE’s are typically used to separate the company from risk that is associated with a specific project. The obvious reason is of course that the
possible failure of the project at hand will not jeopardize the whole company, but it might also prove helpful in the search for external funding. In order for the SPE to be considered a separate entity there is a need for separate ownership interests, often achieved through new investors. What characterizes this type of ownership is the lack of decision-making rights related to relevant activities through voting rights and the fact that the investors are often paid fixed, and previously agreed upon, amounts of remuneration. Furthermore, SPE’s are commonly characterized by high financial leverage, meaning high assets/equity ratio. In order to obtain these loans the parent company guarantees the loans, should the SPE default on future payments. In cases like this, with both the risks and possible pay-offs passed on from the investee to the investor, it is fairly obvious that implicit control exists and, by using IFRS 10, should be consolidated.

4.5 Bright lines

IAS 27 and SIC 12 received criticism due to the fact that their requirements led to a focus on “bright lines”. This led to that the nature of the relationship between a reporting entity and the investee was neglected, instead it provided structuring opportunities (IFRS, 2011). For instance, whereas SIC 12 could lead to a quantitative assessment deciding if the investor had the majority of the risks and rewards the IAS 27 specified that the potential voting rights should be included in the assessment of control when they currently were exercisable. Because of the focus on the date of exercise, the question if the terms and conditions of the instruments were substantive could be forgotten and not be taken into consideration (IFRS, 2011). IFRS 10 moves the focus from these bright lines to a more principles-based approach. This will demand significant judgments from the management in many cases, for example when determining if de facto control exists and entities are required to be consolidated under IFRS 10 (PwC, 2011).

4.6 Summary

The process of determining control is not always straightforward, as the chapter has made clear. In some cases the questions in need of answers can be overwhelming and often times demand a high level of knowledge and judgments. What IFRS 10 provides is, as previously stated, a common definition of control along with more extensive guidelines and requirements regarding whether to consolidate or not. This chapter deals with, what can be considered, some of the most important issues that can arise when involved in consolidations of financial statements. In order to fairly easily summarize the process of determining control, and thereby gaining a greater understanding of the process, the following figure might be of help.
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The new model at a glance

1: Identify the investee
2: Identify the relevant activities
3: Identify how decisions about the relevant activities are made
4: Assess whether the investor has power over the relevant activities

Consider only substantive rights

Voting rights are relevant

Majority of voting rights

Consider

Rights held by others

Less than a majority of voting rights

Agreements with other vote holders

Other contractual agreements

Potential voting rights

De facto power

Rights other than voting rights are relevant

Purpose and design

Evidence of practical ability to direct

Evidence of practical ability to direct

Special relationships

Large exposure to variability in returns

5: Assess whether the investor is exposed to variability in returns

Assess whether there is a link between power and returns

Figure 4.4 First Impressions: Consolidated financial statements. (KPMG, 2011)

4.1 Analysis and discussion

Control is not an easy concept to grasp. There are many factors that can affect if an entity has control as well as if an entity has control over other entities’ relevant activities. IFRS 10 widens the perspective and covers more topics compared to IAS 27 and SIC 12 regarding situations that can result in control and consolidation. This chapter has gone through some of the most important questions that need to be analyzed when an entity
assesses power and control over another entity. This is not an easy task, many situations demand a great deal of professional judgment and there are many variables to take into account. The areas where the differences are most noticeable compared with previous standards when deciding if an entity can control the relevant activities are de facto control, potential voting rights, the principal agent relationship and the new rules that affect the consolidation of structured entities.

4.1.1 Ability to direct the investee’s relevant activities

IFRS 10 introduces the concept of ‘relevant activities’ when assessing control over the investee and requires an entity to identify these relevant activities. These relevant activities are defined as activities that significantly affect its returns and can exist even if those activities only occur under special circumstances. This means that IFRS 10 have a broader view of the control concept regarding which activities of the investee effecting return that should be considered such activities that could lead to consolidation (EFRAG, 2012). This wider view of the control concept is necessary to enable all entities to apply a single consolidation model.

The term relevant activities aim to provide guidance regarding which activities of an investee that should be considered when assessing control. It requires entities to do a more comprehensive analysis of the investor’s relationship to an investee, and it requires the entity to understand the investee’s relationship with other investors.

IFRS 10 will in some cases lead to a simple identification process of the relevant activities of an investee. In other cases this will be more difficult and tedious, especially when an entity is involved with a structured entity of which other investors could have the ability to direct other relevant activities. If two investors through contractual agreements determine the range of business activities of an investee it might be difficult to evaluate if the investors have sufficient rights to the relevant activities to have power over the investee and if one of the investors have power, which one? This questions leads to one of the most central factors of IFRS 10, judgment. The high level of judgment can lead to an incorrect classification of power and loss of relevant information in the financial reports. Correct judgment of relevant activities is one of the most important issues in IFRS 10 and can be very challenging and time consuming, especially in the entities first year adoption when the need to determine what activities should be classified as ‘relevant’ exists.

When identification of the relevant activities has been made, the entity has to determine if they have power over the relevant activities. In cases where control have been established without voting rights, it could be because the entity still have other rights over the investee such as a special relationships or the fact that the entity has a large exposure to variable returns that puts the investor in control over the investee. In conclusion, an entity often has control in other ways than voting rights. This can be the case with special purpose entities where contractual arrangements or special relationships can decide which of the investors that have power over the investee.

Where previous standards unintentionally provided certain structuring opportunities, such as keeping investee’s “off the books”, IFRS 10’s control model gravely impairs these structuring opportunities by taking in to account the ability to direct the investee’s relevant activities even when this ability is merely contractual.

The fact that an investor is exposed to risk and benefits does not on its own lead to consolidation of an entity; a decision has to be made regarding to which extent the entity is exposed to that risk. Structured entities that are autopilots, where no interaction
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between the investor and investee exists, will still not be consolidated. It is the substance of the arrangement that should be considered and not the legal form (EFRAG, 2012). Many variables therefore needs to be considered; the ability to control, the substance of the arrangement, the exposure to risk. There can be a high level of judgment included in these assessments and these different judgments should be included in the reports in order not to lose information. Structured entities that have been constructed so that they in previous financial statements have been kept off balance sheet can now be included. It will become more difficult to hide risk and exposure when control can occur through more conditions than stated in earlier standards.

An example of a structured entity that previously was not included in the financial statements under SIC 12 but will be included when using IFRS 10 follows below.

The investment vehicle is created to purchase a portfolio of financial assets and is funded by debt and equity investors. Investor X holds 30 per cent of the equity and is also the asset manager of the investment vehicle. X is the decision maker and is also the responsible manager for assets upon default.

**Main changes from IAS 27**

![Diagram: Investment vehicle, Debt Investors, Equity Investors including asset manager, X=Asset manager, Asset Portfolio]

Figure 4.5 First Impressions: Consolidated financial statements. (KPMG, 2011)

Under SIC 12, the investment portfolio would be considered as a special purpose entity, which means that the asset manager would not consolidate this investment vehicle based on the fact that it does not bear the majority of risks and rewards.

This investment entity will under IFRS 10 be consolidated by the asset manager. The difference is that IFRS 10 includes X’s ability to direct the relevant activities and use its power to affect its own returns. The result given by IFRS 10 depends on both the ownership of 30 per cent and the fact that X has power over the relevant activities.
Special purpose entities, or SPE’s are, as the name shows, entities created for a specific purpose. In IFRS 10 the name used is ‘structured entities’. Structured entities can for instance be created to manage an investment portfolio like in the above scenario. It can also be created to own and manage a specific asset or to conduct research and development activities for the parent company to name a few possible situations where SPE’s might be suitable. The common denominator in SPE’s is the isolation of risk, both for and from the company/companies behind the SPE, in order to lower the financing cost of the project in question. SPE’s are normally heavily financed by loans in order to lower the cost of capital, but outside equity owners/separate ownership, still can and will, exist in order to separate the parent company from the structured entity. These outside equity owners do not have the same rights as equity owners normally do, such as voting rights. They do have right to returns, but the power to direct relevant activities lies in a contractual arrangement rather than with the outside equity owners. Oftentimes both the lenders and the outside equity owners receive fixed rates of returns, leaving the variable returns for the parent company. This fact combined with indirect control over the relevant activities through the contract can, in substance, mean that the structured entity is a mere extension of the parent company and thereby provide a basis for disclosure which did not, due to a lack of requirements, exist in previous standards.

Alongside the comprehensive disclosure requirements, IFRS 10 also provides guidance with regards to unconsolidated structured entities and when these requirements can and should be applied (IFRS, 2012). The explicitly expressed objective of IFRS 10 is to better reflect the relationship between investor and investee rather than taking in to consideration whether companies will have to consolidate more or less. The concepts in IFRS 10 will most likely have little to no effect at all for most companies keeping in mind that most situations are not very complex. If a company, for instance, owns 70 per cent of the voting rights in a subsidiary it is likely that the way this subsidiary is reported will not change at all. The companies most likely to be subject of change are the companies involved in complex business structures where uncertainty in application and structuring opportunities prevailed using the old standards (IFRS, 2012). One of the more likely consequences for reporting entities involved in complex business structures is the incurrence of costs related to the implementation of the new disclosure requirements that previously was not reported. Another likely consequence is information overload due to the increased level of requirements demanded. There is a risk that not only relevant information is disclosed but also irrelevant information, which might in fact lead to a situation where the relevant information regarding risks gets lost.

The new disclosure requirements are in a lot of ways similar to the disclosure requirements currently in use by US GAAP, which begs the question whether or not IFRS 10 actually is steering its constituents away from or towards bright lines. The consensus in countries applying the IASB framework as of today seems to be that principles-based accounting is the best way to avoid uncertainty and opportunistic behavior. In reality it is not far-fetched for one to argue that the extent as to which different methods and applications are being prescribed actually is steering the accounting practices of today towards, rather than away from, rule based accounting.
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4.1.2 Agent/Principal-relationships

As previously mentioned, neither IAS 27 nor SIC 12 gives any specific guidelines regarding situations where power is delegated to an agent. Therefore, it has earlier been unclear how to assess agency relationships within the context when determining control (IFRS 10, 2012). Depending on which of the standards that was used, different outcomes were often the case. Due to that fact, the future goal of IFRS 10 is to "reduce diversity in practice by providing a principle regarding agency relationships, and application guidance and examples on how to apply that principle" (IFRS 10, 2012). When determining whether a decision maker is an agent, IFRS 10 introduces a number of factors to consider. The scope of decision-making authority, the rights held by other parties, the decision maker's remuneration and the decision maker's exposure to variable returns from other interests that it holds in the investee is examples of these.

How will the transition to IFRS 10 affect companies in practice regarding the agent/principal-relationships when consolidating financial reports? To illustrate this, a possible scenario will be presented which describes how this scenario would be handled, both before and after the introduction of IFRS 10 (IFRS 10, 2012).

A fund manager (A) has 45 per cent shareholding in fund B. The fund manager manages this fund within defined parameters. The fund’s purpose and the investment parameters, which the fund manager can invest within, are defined by the constitution of the fund. It is also a requirement that the fund manager acts in the best interests of the shareholders. Though, the fund manager has discretion about the assets in which fund B will invest, within the defined parameters.

Earlier observations have been made that shows that uncertainties have occurred when deciding if this relationship would be within the scope of IAS 27 or SIC 12 (IFRS 10, 2012). Those who assumed that this relationship should fall under the requirements of IAS 27 concluded that the fund manager should consolidate fund B. The reason for this is that the fund manager had the power to control and direct the operating and financing activities of the fund, which would lead to obtaining benefits from those activities. The fund manager would also be required to make disclosures about the nature of its relationship with fund B due to the fact that it was consolidated without a majority of voting rights. Those who assumed that this relationship should fall under the requirements of SIC 12 would not consolidate fund B since the fund was not exposed to the majority of risk and rewards that would arise from fund B. As a result of this, the fund manager would not have any requirements to make any specific disclosures about the relationship.

According to IFRS 10 the fund manager in this scenario would consolidate fund B since it should be seen as it controls the fund. The fund manager has the power to direct the funds relevant activities by directing the investment decisions, got exposure to variable returns from the fund as well as it can use its power to affect the amount of its returns. Regarding the disclosures that would have to be made in this scenario, these are handled in IFRS 12. What should be noted in this scenario is that there is an assumption that the other shareholders do not hold substantive removal or other rights that would change the decision-making authority of the fund manager. To conclude this scenario, it is quite obvious that the introduction of IFRS 10 will decrease the uncertainty of how to assess agency relationships with the removal of the possibility to choose between two standards. A change in the assessment of an agency relationship could lead to a change in when an investee should be consolidated. As a result of this, different key metrics in the
parent company could be affected when consolidating an investee that previously should not be consolidated.

4.1.3 Potential voting rights

Potential voting rights must be considered when assessing control under IFRS 10. This means that an entity must consider all the rights they and other investors have over an investee, including the purpose and design of the investee. A new focus of IFRS 10 is therefore the economic characteristics of potential voting rights. This judgment may become difficult when deciding if the voting rights are substantive or protective. Another important issue to consider is if the design and purpose of the investee give rise to potential voting rights. The entity needs to do an analysis of the basic terms and then analyze the motives and reasons for these terms (EFRAG, 2012).

The definition that could be found in IAS 27 focus on the exercisable opportunity of voting rights, this gave a constructive opportunity; voting rights could be constructed so that they were not temporarily exercisable at the reporting date, they could for example have a contract where the voting rights were only exercisable 51 weeks of the year. Companies could therefore judge the voting rights as not substantive. Others concluded these voting rights by their substance and this lead to inconsistency in practice. IFRS 10 tries to create consistency in practice; financial reports will better reflect the substance of the entity's relationship if this new model is applied correctly.

The result of the new concept of deciding about potential voting rights and if they are substantive or not, is one of the ways IFRS 10 is trying to create more substance in the financial reports. This is shown by our previous example; when an investor has potential voting rights that are only exercisable 50 weeks of the year and exercising these voting rights would give the investor the majority of the total voting rights, this investee should be consolidated. This reduces structural opportunities for entities; the substance of the arrangement will be shown in the financial reports and not the created form of the arrangement. This is one of the steps IFRS 10 in taking to fulfill the fair view concept found in the conceptual framework.

4.1.4 De facto control

One of the things that IFRS aim to improve with their new standard is the concept of de facto control, or control in absence of the majority of the voting rights. This has previously been poorly explained in IAS 27 and the different views on whether or not it at all explains how to determine de facto control have been many (EU, 2005). Instead of giving guidelines on how to determine de facto control, IAS 27 and SIC 12 have relied more heavily on the bright lines when a company was to decide if it was in control of another entity. This often led to more quantitative measurements, and more focus was put on when a company exercised their rights rather than what type of right the company possessed (IFRS, 2012).

IFRS 10 have acknowledged the problem regarding determining de facto control and is trying to solve it with their single control model. The basic thought of a single control model is that it is possible to use it for all kinds of entities in determining control, something that erase the uncertainty previously experienced in IAS 27 and SIC 12. This control model designed in IFRS 10 specifies the requirements that were vaguely explained in its predecessor, and also provide additional information and guidelines. The
new standard also states that control depends on the practical ability of an entity to direct relevant activities of an investee unilaterally, something that differs from earlier standards where the focus was on who was having the majority of the voting rights. IFRS 10 also specifies more detailed in circumstances where control exists without a majority of the voting rights, something that following example will show:

An investor holds 48 per cent of the voting rights of an investee, and the remaining voting rights are held by different owners, who individually does not own more than one per cent each. Moreover, these owners do not have the ability to come together and make collective decisions, so decisions about the relevant activities has to be made through the approval of a majority of cites cast at relevant shareholders’ meetings. Last meeting, 70 per cent of the votes were used.

In IAS 27, there are few guidelines to help deciding about control without a majority of the voting rights and it seem like bright lines in each country were a decisive point when making such a decision. Therefore it would depend on the country’s legislation in order to decide if de facto control exists or not. If IFRS 10 would be applied in this case, it would consider the circumstances as a factor for concluding control. The investor with 48 per cent of the voting rights, given that the rest of the shareholders only have one per cent each, would probably be concluded that it is in control of the investee. It has enough power to direct the relevant activities due to the fact that it has exposure to variable returns and the ability to affect those variable returns through its voting rights.

IFRS’ intention with fewer bright lines and lean towards more specific guidelines is to make the accounting concerning consolidation more consistent and to facilitate for entities in making the right decisions in situations when there is no shareholder that possesses more than 50 per cent of the voting rights. While it is facilitating for entities in that perspective, it also demands a lot of knowledge about an investor’s substantive rights and other shareholders, something that may be difficult to achieve in some industries. Though the change in judgment regarding situations like the example above speaks for improved disclosure in the consolidation of financial statements, it is not enough to draw any general conclusions about the effect of the IFRS 10 standard as a whole. Before the standard is fully implemented and used for some time, it will not be possible to know exactly what the total difference will be for consolidating entities.

4.1 Conclusion

This chapter has pointed out the main differences between IAS27/SIC 12 and IFRS 10 and analyzed how this will affect consolidated reporting within entities. The aspects in which the most explicit differences can be found in IFRS 10 compared with its predecessors are the judgment of relevant activities, principal/agent-relationships, de facto control, potential voting rights and structured entities. These differences, together with more guidelines and less bright lines, result in higher demand of the accounting profession. IFRS 10 introduces a wider view of the control concept that puts the substance of the relationship in focus rather than the form. The new control model that will be applied by all sorts of entities is the major difference between the old IAS 27 and the new IFRS 10, while the shift from a rule based to a principles-based standard is the most fundamental change between SIC 12 and IFRS 10.

It is clear that IFRS 10 could create consistency in the consolidation procedure. All entities will follow the same guidelines and this will, if applied correctly, enhance the
comparability between companies’ financial reports. If relevant information is presented in the financial statements, the standard will lead to a better view of a company’s financial situation and provide users of the financial statements with more relevant information.

Beside implementation costs there will be some extra costs each year due to the continuous assessments required as a result of the complexity in the procedure of determining control. Risks associated with implementation of this standard are correlated with the scope of the standard. If control is determined incorrectly due to all variables included in the assessment, information brought on to the balance sheet will be incorrect or irrelevant. Irrelevant information could lead to relevant information being lost. Different information could be brought in to the financial statements and therefore make it more difficult for users to compare companies.

4.1.1 Further research

IFRS 10 will be implemented in January 2013. One of the more obvious starting points for further research is how the actual implementation of IFRS 10 has affected both the users and the preparers of financial reports. An in-depth study of regional differences in the application of the standard with regards to legal differences could be both important and interesting.
Consolidation of financial statements

References

Internet
Chapter 5
IFRS 11

Moa Ramberg
Martin Rodenberg
Nathalie Thörnqvist

5.1 Introduction


The project originally started out as a research project between the International Accounting Standards Board (IASB) and the Australian Accounting Standards Board, who did the initial research, and later became a convergence project between the IASB and the Financial Accounting Standards Board (FASB) intended to reduce the differences between the two organizations (Deloitte, 2012). Even though it started out as a convergence project, in the end the IASB developed the standard without any participation from the FASB (Ericsson & Lindgren, 2011).

IAS 31 – Interest in Joint Ventures had not been revised since its release in 1990 (IFRS 2012). The IASB felt that there were two problems with the standard that impaired the quality of the accounting of joint arrangements. The first problem with IAS 31 was that the arrangement’s legal structure was the only thing that determined the accounting classification, and the second was that the entities could use more than one method for the accounting of interests in jointly controlled entities. IASB also improved the requirements for disclosing information.

In this chapter we will attempt to answer the following questions:

- What is new in IFRS 11, in comparison with IAS 31?
- How do the differences affect the company and company’s financial situation?
- How do the transitions of accounting method affect the transparency of the financial information?
- What are the benefits to the company of implementing IFRS 11?

These questions are of immediate interest since the standard will be become effective 1 January 2013 and for the members of the EU will be mandatory from 2014. The effect
IFRS 11

may have a great influence on the financial statements for companies that will affect the view of the companies from the investors’ perspective.

After reading this chapter the reader should be able to:

• Understand the new content of IFRS 11.
• Understand the differences between the accounting methods and how they affect the companies’ financial statement.

5.1.1 Disposition

The chapter will address the differences between joint ventures and joint operations and how companies should classify, conduct and account for them. It will then discuss the accounting treatment for the different types of joint arrangements and explain the difference between them. Finally the article will take a brief look at the convergence between IFRS 11 and US GAAP before it moves on to the analysis and the conclusion where the questions asked in the introduction will be answered.

5.1.2 Definitions

• Joint arrangement is an agreement between two or more parties in which they share influence over decisions regarding a project they have commenced through a legal agreement (Jonsson, 2011). In order for an agreement to be made, the parties must agree on the essential decisions regarding the project’s revenue.
• Joint operation is a joint arrangement in which all parties have equal rights to profits and share responsibilities for debts (Ibid.).
• Joint venture is a joint arrangement in which both parties have equal right to the net assets but not the direct right to profits and debts (Ibid.).
• Proportional consolidation is a way to consolidate joint arrangements where you split all the accounts and consolidate them to your financial statements (Ericsson & Lindgren, 2011).
• The equity method is a way to consolidate the numbers from the joint arrangements where you only add the net income and net assets to your financial statements (Ibid.).
• Financial leverage is the ratio of debt in the company. A high ratio of debt increases the interest cost but makes the owner base smaller and the share of gain or loss greater (www.businessdictionary.com). This makes the potential gain greater but also raises the risk of the company.
• Hedging is a technique for reducing the risk of fluctuations in the prices of commodities, currencies and securities (Ibid.). A hedge may reduce future losses as well as future gains.
5.2 Joint arrangement

IFRS 11 generally replaces the previous standard (IAS 31) for how to classify, conduct, and account for joint arrangements (Cairns, 2011). In order for a joint arrangement to commence, two or more parties need to agree on all relevant decisions regarding the project’s profit. This is called “joint control” and is defined by IFRS 10 - Consolidated Financial Statements (Ericsson & Lindgren, 2011). If the parties of an agreement can make important decision were not all parties involved agree, there is not a joint arrangement. In the cases where joint control not is forthcoming, IFRS 11 is not applicable, and the company should instead account for the project in accordance with IAS 28 - Investments in Associates and Joint Ventures, IAS 39 - Financial Instruments: Recognition and Measurement and/or IFRS 9 - Financial Instruments.

A joint arrangement, in its earlier term “joint venture”, was most common in the US with 37,10 % of the worlds’ accounting for joint venture, or more specific 31 952 agreements of joint venture accounted for during the years 1990 – 2010 (Effect analysis, IASB, 2011). The total number of joint venture agreements accounted for during the same time period is 86 135. Put in to perspective of industries instead of geographic location, joint venture was during this time period most common in the business service industry, were over 20 % of the joint venture agreements accrued.

5.2.1 Classifying

Joint arrangement is either to be classified as a joint operation or as a joint venture. IAS 31 uses the term joint venture in favor of joint arrangement; thus has the term joint venture become less used due to the introduction of IFRS 11 (Cairns, 2011). According to IFRS 11, the general rule is that a joint arrangement should be classified as a joint operation as long as it is not specifically a joint venture. The classification should with the new standard reflect the true content of the agreement, instead of the earlier legal term.

IFRS 11 p. 17 puts it as followed:

An entity applies judgment when assessing whether a joint arrangement is a joint operation or a joint venture. An entity shall determine the type of joint arrangement in which it is involved by considering its rights and obligations arising from the arrangement. An entity assesses its rights and obligations by considering the structure and legal form of the arrangement, the terms agreed by the parties in the contractual arrangement and, when relevant, other facts and circumstances (see paragraphs B12–B33).

When determining if a joint arrangement is a joint venture or a joint operation there is number of questions that need to be answered. The picture below will illustrate how the classification can be done by answering the question one by one, if any one of the last four questions is answered by a “yes” or the first questions is answered by a “no” the joint arrangement will be classified as a joint operation.
IFRS 11

One example regarding aforementioned classification is the joint arrangement between GE and Snecma, an aircraft engine production arrangement (Cairns, 2011). The production takes place in two separate factories that holds their own production costs but GE and Snecma shares the revenue. This arrangement has previously been regarded as a joint venture but should according to IFRS 11 most likely be classified as a joint operation because the company does not have the direct right to the assets and obligations for the liabilities. However, if both companies had agreed on having one single factory in which they produced their engines, wherein both parties share revenue and production costs, it should be classified as a joint venture instead.

IFRS 11 changed the rules for how joint ventures should be accounted for; it was previously acceptable to choose between proportional consolidation and equity accounting (New Standards for off Balance Clarity, 2011). However, subsequent IFRS 11’s introduction, only equity accounting is allowed for joint ventures. A joint operation instead accounts for its assets, liabilities, income and expenses resulting from its interest in the joint operation. IFRS 12 specifies the disclosure requirements for parties with joint control of a joint arrangement, IFRS 11 p. IN 11.

Two or more parties can be involved in more than one joint arrangement at the time; even in the same legal contract more than one joint arrangement can take place. If more
than one joint arrangement originates from the same contract they shall be classified and accounted for individually, IFRS 11 p. 18.

5.2.2 Proportional consolidation
According to IFRS 11, proportional consolidation is the method to account for joint operations (Ericsson & Lindgren, 2011). In this method the companies divide the total amount of the assets. Each company then account for their proportion of the assets. This include that the company also account for their share of the capital and debt. Each post from the joint arrangement will be included in the balance sheet.

5.2.3 The equity method
The equity method is the only allowed method when accounting for a joint venture according to IFRS 11 (Ibid.). In this method the company only uses the net assets of the arrangement in their balance sheet. This means that the companies are only able to add net assets and capital and no debt. The share of the debt will decide how much asset you can add to the balance sheet.

5.2.4 Example of the differences between the methods

<table>
<thead>
<tr>
<th></th>
<th>Proportional method</th>
<th>Equity method</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed assets</strong></td>
<td>15000</td>
<td></td>
</tr>
<tr>
<td><strong>Investments in joint venture</strong></td>
<td></td>
<td>12500</td>
</tr>
<tr>
<td><strong>Accounts receivable</strong></td>
<td>3000</td>
<td></td>
</tr>
<tr>
<td><strong>Inventory</strong></td>
<td>2000</td>
<td></td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>21000</td>
<td>12500</td>
</tr>
<tr>
<td><strong>Accounts payable</strong></td>
<td>1500</td>
<td></td>
</tr>
<tr>
<td><strong>Deferred tax</strong></td>
<td>3000</td>
<td></td>
</tr>
<tr>
<td><strong>Loan</strong></td>
<td>4000</td>
<td></td>
</tr>
<tr>
<td><strong>Total debt</strong></td>
<td>8500</td>
<td>0</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td>12500</td>
<td>12500</td>
</tr>
</tbody>
</table>

Income statement
As seen from the example, the proportional method adds $8500 more to total assets in the balance sheet than the equity method ($21000-$12500) (Ericsson & Lindgren, 2011). To cover for this it also adds this sum to debts and the rest $12500 to equity. The equity method will only add $12500 to equity, the same amount that it adds to total assets.

Proportional consolidation will generate higher revenues. In this case the joint arrangement sells for $30000 (Ibid.). Proportional consolidation adds all of this to sales and turnover meanwhile the equity method does not. However, a proportional consolidation will also have to add the costs of $2000 from the arrangement that results in a $10000 gain, which will be added to the consolidated gross profit in the main income statement. When using the equity model the net result of $10000 will be placed in a separate post, which later adds up to net profit.

5.2.5 Financial impacts

The changes followed by the implementation of IFRS 11 will affect the financial ratios of the company, which may affect conditions for loans and agreements (Ericsson & Lindgren, 2011). That is why it is important that the company in the case of a change in accounting method explain the reasons for their new numbers in the financial report.

Some of the most important ratios that would change are profitability, total asset turnover and financial leverage (Effect analysis, IASB, 2011, p.23). A change in accounting method from proportional consolidation to the equity method will have the following effects on the financial ratios;

- **Profitability:** (Net income/Revenue) Because of the decrease in revenues but a maintained net income the net method will increase the ratio of profitability.

- **Total assets turnover:** (Revenue/Assets) Both revenues and assets will decrease. The effects in this ratio depend on the proportion of the sales and assets of the joint ventures to the company. If the proportion sales/assets is higher in the joint venture the ratio will increase.

- **Financial leverage:** (Debt/Shareholders equity) This ratio will decrease because we eliminate the proportion of debt from the joint venture when consolidate the statement.
The transition to the equity method would also affect the statement of cash flows by removing the cash flow from reported operating, investing and financing cash flow and place it as dividends received from joint ventures (Ibid. p.22).

### 5.2.6 Business impacts

The impacts on the business should be considered when adopting a new method. The following aspects should be considered when adopting the equity method in favor of proportional consolidation.

- **Borrowing costs**: In a joint venture with credit and borrowing costs from the mother company for a qualified asset, the company would have to capitalize its borrowing cost according to IAS 23 (Ernst&Young, 2011, p.56). However, this would not be possible when using the equity method because the net asset is not considered to be a qualified asset.

- **Hedging**: In a proportional consolidation it is possible to apply hedge accounting to the company’s share of assets, liabilities, firm commitments and forecast transactions (Ibid.). When using the equity method the company is only able to apply hedge accounting on the net assets of the joint venture. A transition to the equity method could lead to a less effective hedging by the company. However it would be possible for the operator to hedge these transactions separately inside the joint venture.

- **Other business impacts**: When adopting the equity method, a lot of external information about the joint venture will be lost and it is recommendable that the company reviews the internal control over its joint arrangements (Ibid. p.60). Using the net equity method the management of the company has less insight in the joint arrangement and it is also recommendable that they try it for revaluation and impairment. A transition may also result in a taxable gain or loss that should be reviewed.

### 5.2.7 Convergence between IFRS 11 and US GAAP

As mentioned above in the introduction, even if the plan was to reach convergence between the IASB and the FASB, this has not yet been achieved (Ericsson and Lindgren 2011). IFRS 11 will reduce the differences, but they will not disappear entirely. The first major difference is that US GAAP in some cases (construction and extractive industries) allows the companies to use proportionate consolidation while IFRS 11 only allows equity accounting. The other big difference between them is that US GAAP focuses on the legal form of the agreement while IFRS 11 sets focus on the rights and obligations of the agreement instead of the legal definition.

### 5.3 Summary

IFRS 11 has introduced new recommendations regarding the presentations, classification and the accounting for joint arrangements. The rights and obligations that occur due to the joint arrangement decide the classification. With a direct right to the rights and obligations it is classified as a joint operation otherwise it is classified as a joint venture.
IFRS 11

If it is classified as a joint operation the company is obligated to use proportional consolidation and if it is classified as a joint it is obligated to use the equity method when accounting for the arrangement. When using the proportional consolidation the company accounts for all assets and liabilities as well as all the income from the joint arrangement meanwhile when using the equity method it only accounts for the net assets and net income.

5.4 Analysis and discussion

IFRS 11 has a great impact internal as well as external, on the accounting in firms with a large share of joint arrangements. The main issues are different numbers of assets and sales, decreased transparency and an increased workload for the accountants.

5.4.1 Accounting impacts

Due to the implementation of IFRS 11, there will be two options for classification of a joint arrangement, joint operation and joint venture. The two different classifications use two separate accounting methods that affect the company’s financial standing in very different ways as discussed earlier in this chapter. When the classification affects the company’s financial standing in a direct way, it is easy to assume that the company will try to classify the project in the category that best fits the company’s wishes of financial impact from the project. A comparison between different companies and projects requires more intense reviews by the company’s external auditor, otherwise there is a large risk that companies will not make an objective classification of the project, and instead will try to twist the circumstances to fit the company’s wish for classification. This is something that the auditor earlier did not have to pay much attention to, when the company according to the earlier standard was free to choose their accounting method.

The classification will be decided by how different placements of risk from the agreement are formed and how the external circumstances are, rather than by the legal form of the agreement. This makes it possible already when signing the agreement to consider how the different placement of risk will influence the accounting of the project. This will benefit companies with a high degree of strategic synergy and good communication between the different sections of the company. If the company wishes to enlarge their “balance sheet total” they would prefer the proportional consolidation method to account for the project and formulate the agreement to give the the company direct right to the assets and obligations for the projects liabilities, in short terms classifying it as a joint operation. If the company does not work together as a unit, the operating section formulates an agreement that the accounting section later on might have trouble to handle when accounting for the agreement, so it fits the financial goals set by the company. A company with a larger level of synergy would probably have taken the projects accounting under consideration already when deciding and signing the agreement.

5.4.2 Transparency and impacts for external users

When adopting IFRS 11 and converting a joint operation to a joint venture the management has to consider the effects on the external image of the company from the investor’s perspective that does not have access to the internal audit of the company. The
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compagny will start to use the equity method instead of proportional consolidation. A
transition from the equity method to proportional consolidation will have great effects on
the transparency of some parts of the financial information. When using proportional
consolidation the external users are able to see all the assets owned by the company as
well as all the debts the company is obligated to pay. When using the equity method the
users will not be able to see this information and the accountants will only be able to
account for the net assets. This implies that an adoption of IFRS 11 and a transition to a
joint venture decreases the transparency of the financial information in the balance sheet
of the company. The transparency of income will also decrease when cutting the income
and cost from the joint ventures and place them as a gain or loss from joint ventures in a
separate account outside the operational income. The external user will not be able to
know the sales, cost and turnover of the entities controlled as joint ventures by the
company.

How this lack of transparency will affect investors and lenders is difficult to predict.
It is possible that they are not going to consider the joint ventures when they cannot see
them that well in the financial statements. Some investors may only consider the
operating result and cash flow which will be affected when removing the sales and cost
from the joint ventures meanwhile those who consider the net margin will get a different
percentage even though the net result stays the same. Let us say that a company has a
large share of joint arrangement that generates great returns for the company. When
classifying the arrangements as joint ventures instead of joint operations and adopting the
equity method, the gains from all these ventures will be removed from the result from
operation and makes the company less attractive for the investors that consider net
operating cash flow. Meanwhile the transition will have a positive effect on the net result
margin when adding the gains directly to the result from operations, which makes the
company more attractive for investors that considering this ratio.

Other key ratios that are important for the investors are financial leverage or the
equity ratio. When adopting the equity method the equity ratio will increase and the
company will appear more solid and less dependent on loans. This will make the
company more attractive for lenders and investors because the increased equity ratio
makes the company appear more safe and able to pay off new debts. A transition to the
equity method would decrease the transparency of debts and equity in the balance sheet
and the company would be able to get into debt without anyone noticing, using the joint
venture to hide the debts.

The transition from proportional consolidation to the equity method would have some
negative effects on the transparency of the company’s financial situation. How much the
investors should take this under consideration depends on how well the joint ventures are
presented and their magnitude in the company.

5.4.3 Advantages and disadvantages with implementing IFRS 11

Like all new standards the implementation of IFRS 11 carries both advantages and
disadvantages to the companies. One of the advantages is that the statements focus on
the rights and obligations arising from the arrangement instead of the legal form.
Companies that have similar rights and obligations will now be accounted for in the same
way. This will lead to increasing comparability between companies. The users of
financial statements will save both time and money since less work is needed when the
users compare financial statements from different companies. There are also some
disadvantages with implementing IFRS 11. The companies will have to educate their staff in the use of IFRS 11 and they will also have to explain the changes in the financial statements to the users. Both of these costs are one-off and should not affect the companies in the long run. It is also important to consider that the preparation of the financial statements will take more time with the implementation of IFRS 11. More time will be spent when the new standard requires the companies to consider the rights and obligations from the arrangement when classifying the form of the arrangements, instead of simply using the legal form. The extra cost will vary depending on how many joint arrangements the companies are involved in. These costs are not one-off costs but they will probably decrease over time, as the staff gets more experienced and learn how to make the classifications.

Another reason for the implementation of IFRS 11 was to reach convergence between IFRS and US GAAP and this goal was partially achieved. It is possible that the IASB thought that the advantages with IFRS 11 were greater than the disadvantage with not reaching total convergence between the two standards. This decision is probably popular with those who only come in contact with financial information from companies who use IFRS, because the comparison will be simplified. There are users that need to compare financial information from companies that use IFRS with information from those that use US GAAP. They will have higher comparison costs than the other users, but probably lower than under IAS 31, because of higher convergence.

5.5 Conclusion

IFRS 11 uses the form and true content of the arrangement instead of the legal form of the agreement. Due to the implementation of IFRS 11, the company is no longer free to choose method to use when account for the joint arrangement, instead the classification of the project decides the method for the accounting. The classification of arrangement decides if the company shall use proportional consolidation or the equity method. The types of accounting methods have different impacts on the financial reports and differ in the size of turnover and profit margins as well as the size of the assets and equity. Also the degree of transparency differs, which affects the risk awareness when investing in the company.

The company will have to consider the accounting effect of their arrangement earlier with the new standard, due to the effect that now follows the classification. Companies with a high degree of strategic synergy in the different sections of the company will benefit due to the higher ability to make a proactive choice with choosing the character of the joint agreement.

IFRS 11 has first and foremost made it easier to compare different companies that account in accordance with IFRS. A purpose with IFRS 11 was to reach convergence with US GAAP, this target was not reached, but IFRS 11 reduced the differences between the standards, and also increased the possibility to compare companies that accounts in accordance with the two standards.

It is also important to remember that the companies’ costs for preparing financial statements will rise. As mentioned in the analysis, these costs will probably decrease over time when staff that prepares the financial statements gets more experience. This is only speculation and further studies will be needed to evaluate both the positive and negative effects of the standard.
5.6 Questions
1. What are the main differences between joint operations and joint ventures?
2. Which method should you use when you account for a joint venture?
3. What are the differences between proportional consolidation and the equity method?
References


Section 4
Selected exposure drafts
Chapter 6
Lessee Accounting

Emelie Bojmar
Malin Peterssson

6.1 Introduction

Leasing as a form of financing has increased significantly in importance during the last decades. There are several reasons for the increased use of leasing. According to Schallheim (1994), the flexibility regarding the lease term and the lease payment, tax benefits, risk sharing and significant cost savings represent some of the most important benefits of leasing assets for the lessees. Most benefits are related to both operational and finance leases. However, a prominent cost saving aspect of lease financing is the possibility for a company to obtain off-balance sheet transactions, which only is achievable when classifying a lease as operational. Through off-balance sheet financing, the lessee can acquire and utilize assets without affecting financial numbers and key ratios.

Although off-balance sheet accounting represents an important reason for lessees to lease assets, the accounting method has been subject to considerable criticism. According to the International Accounting Standards Board (IASB, 2010a) the main issue is that the distinction between different lease contracts leads to a lack of comparability and undue complexity. Also, the current model omits relevant information about the rights and liabilities related to the lease. As a result, many users of financial statements adjust the information to reflect assets and liabilities related to operational leases.

In consideration, the IASB (The Board) sought a solution through the implementation of the Exposure Draft (ED/2010/9). At its core, the ED/2010/9 would require both the lessee and lessor to apply a right-of-use model when accounting for leases. In terms of the lessee, the right-of-use model would require the lessee to recognize both assets and liabilities during the lease term. Most importantly, this would display the origins of assets and liabilities for all leases, contrasting with current requirements that reflect only assets and liabilities arising from leases classified as finance leases. The ED/2010/9 would additionally dictate accounting standards for the majority of leases, leading to increased practicality and comparability of financial statements.

Though potentially beneficial in a multitude of regards, the IASB’s (2010a) ED/2010/9 has been met with criticism. In particular, criticism has been raised by companies with considerable amounts of operating leases that, as a result of the implementation of the proposed model, would face a substantial heightening of their assets and liabilities. The concern focuses upon their potential financial ratio deterioration and subsequent difficulties in access to financing. Commonly, such substantial changes will face an initial period of unease, as companies confront new standards and potential costs to facilitate implementation.
The purpose of this chapter is to obtain a greater understanding for the proposed lessee accounting model and how implementing it would change lessee accounting. The core objective is to delve into the fundamental effects of the Board’s proposed lessee accounting model, and evaluate the potential advantages and disadvantages that it may entail. Since there are different opinions about what are valid advantages and disadvantages by implementing new accounting standards, the study will focus on answering the question: “What would be the most significant advantages and disadvantages by implementing the ED/2010/9?”

6.1.1 Disposition

The chapter begins with a section describing the current lease standard, IAS 17. Following section provides a presentation of the proposed new lease standard. The section also outlines the major problems with lease accounting according to the IAS 17, addressed by the ED. Next section carries on with a discussion of the proposed concerns related to the implementation of the new standard. The chapter will continue with a description of the qualitative characteristics in the IASB’s Conceptual Framework (CF) for financial reporting and the study’s theoretical approaches, which are used in order to analyze the potential outcomes of the new lease standard. The analysis and discussion of the study will then be presented, followed by the last section summarizing the conclusions of the study.

After reading this chapter, the reader should be able to:

- Understand the core principle of the proposed lessee accounting model.
- Understand the major differences between the ED/2010/9 and IAS 17 in regard to lessee accounting.
- Understand what the most significant advantages and disadvantages would be by implementing the proposed lessee accounting.

6.2 Definitions

The definition of an asset, according to the CF, is:

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(IASB, 2010b)

The definition of a liability, according to the CF, is:

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

(IASB, 2010b)
Lessee Accounting

The definition of a lease, according to IAS 17, is:

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

(IAS 17 p. 4)

The definition of a lease, according to the ED/2010/9, is:

A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.

(IASB, 2010a)

The lessee accounting model in IAS 17 is based on a risks-and-rewards approach, which is related to the classification of the lease as follows;

Leases are required to be classified as either finance leases or operational leases. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred. An operating lease is a lease other than a finance lease.

(IAS 17 p. 4)

The lessee accounting model in the ED/2010/9 is based on a right-of-use approach, which means;

A lessee would recognize an asset representing its right to use the leased ('underlying') asset for the lease term (the 'right-of-use' asset) and a liability to make lease payments.

(IASB, 2010a)

6.3 IAS 17 Leases – Lessees Accounting

An agreement that fulfills the definition of a lease according to the IAS 17 p. 8 is classified as either a finance lease or an operating lease. The classification of leases depends upon the distribution of the risk and the rewards incidental to the ownership of the leased asset. In the situation of a finance lease, the risks and rewards of owning the lease are transferred from the lessor to the lessee, whereas in the case of an operating lease, the lessor carries the risk for the whole leasing term.

Decisive in determining whether a lease agreement is of a financial or of an operating character, is the economic substance of the transaction. For a lease to be considered financial, according to IAS 17 p. 10, the following criteria, individually or combined should be met by the lessee:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable, that at the inception of the lease, it is reasonably certain that the option will be exercised.

The lease term is for the major part of the economic life of the asset, even if title is not transferred.

At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

The lease assets are of a specialized nature such that only the lessee can use them without major modifications being made.

Thus, the criteria in IAS 17 p. 10 determining the classification only constitute examples of situations in which a leasing contract shall be classified as finance lease. According to IAS 17 p. 12, all lease contracts can be classified as operational leases if it is clear from other features that the rewards and risks associated with the lease are not substantially transferred to the lessee. Thus, lessees are given some discretion in the classification of a lease agreement.

**6.3.1. Recognition and Measurement**

The classification of the lease contract determines how the lease should be reported in the financial statements (IAS 17 p. 20). The lessee of a finance lease shall, at the commencement of the lease term, recognize the lease payments of the finance lease in the statement of financial positions as assets and liabilities. The finance lease should be reported at the lowest value between the fair value of the leased asset and the present value of the minimum lease payments. The discount rate used depends upon the practical applicability. If the interest rate implicit in the lease is practicable to determine, it should be used. Otherwise, the lessee’s incremental borrowing rate should be used. The lease payments arising from operating leases shall be expensed on a straight-line basis over the lease term in the statement of comprehensive income (IAS 17 p. 33). However, if there is another systematic basis that better reflects the user's benefit over time, it should be used.

In the subsequent measurement, the minimum lease payment of the finance lease shall be divided between interest and reduction of the outstanding liability (IAS 17 p. 25). The interest shall be allocated over the lease term so that each accounting period is charged by an amount corresponding to a fixed interest rate for the recognized liability of the reported period. The recognitions of the payments of the operating lease will not differ in the subsequent measurement from the reported expenses in the initial recognition.

Accordingly, the finance lease could be compared to a debt-financed purchase, while the operating lease is comparable to a regular rent contract.

**6.3.2 Disclosures**

According to IAS 17 p. 31 the lessee has to provide extended information for finance leases about;
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• the carrying amount of the leased asset,
• the reconciliation between total minimum lease payments and the assets present value,
• the amounts of minimum lease payments at balance sheet date and the present value thereof,
• the contingent rent recognized as an expense,
• the total future minimum sublease income under non-cancellable subleases, and
• the general description of significant leasing arrangements, including contingent rent provisions renewal or purchase options, and restrictions imposed on dividends, borrowings, or further leasing.

According to IAS 17 p. 35 the lessee has to provide extended information for operating leases about;

• the amounts of minimum lease payments at balance sheet date under non-cancellable operating leases,
• the total future minimum sublease income under non-cancellable subleases,
• the lease and sublease payments recognized in income for the period
• the contingent rent recognized as an expense, and
• the general description of significant leasing arrangements, including contingent rent provisions, renewal or purchase options, and restrictions imposed on dividends, borrowings, or further leasing.

6.4 Replacing IAS 17

Due to the extensive use of leasing as a source of finance, it is important that lease accounting provides users with a complete and understandable depiction of a company's leasing activity. According to IASB (2010a), the current lease standard has been criticized, primarily because of its permissiveness regarding off-balance sheet accounting and its numerous rules. As a response to the critique, the IASB has identified leases as one of the top priorities for improvements and for convergence with the FASB.

The project with the new lease standard was added to the IASBs agenda in July 2006. Since then, the Board has published a discussion paper, Leases: Preliminary Views, in July 2009 and an ED, Leases, in August 2010. The ED/2010/9 was open for comments until December 2011 and the Board started deliberations January 2012. It is expected that the revised ED/2010/9 on lease accounting shall be published at the end of 2012.

6.4.1. Changes in the Core Principle

The proposed model in the ED/2010/9 published by the IASB (2010a) would significantly change the accounting principles for lessees. The core principle in the
proposed lessees accounting model is based on a right-of-use approach instead of on risks and rewards, which is the case in IAS 17. The right-of-use approach implies that at the day of lease commencement, i.e. the day the lessor makes the underlying asset available for use by the lessee, the lessee would recognize an intangible asset for the right to use the underlying asset and a liability to pay rentals.

Lessees with a significant portfolio of assets held under operating lease would be most affected by the change proposed in the ED/2010/9. According to the ED/2010/9, lessees would recognize all leases as assets and liabilities. This would result in operating leases no longer being an accounting option.

For leases currently recognized as operating leases, the rent expense would be replaced with asset amortization and interest expense. For leases currently classified as finance leases, the proposed model would be less fundamental. For these leases the most significant changes would be most significant in regard to measurement of the assets and liabilities arising from the lease.

6.4.2. Changes in Recognition and Measurement

According to IASB (2010a p.12) the obligation to make lease payments would be recognized at the present value of the lease payments, discounted using the lessee’s incremental borrowing rate at the day of lease commencement. Though if the rate the lessor charges the lessee can be readily determined, it should be used. At the same time the right of use asset would be measured at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee.

After the day of the lease commencement the lessee should measure the liability to make lease payments at amortized cost using the effective interest method (IASB 2010a p.16) and recognize interest expense using the interest method. The right of use asset would be measured at the amortized cost or to the fair value in accordance with the revaluation model in IAS 16. This accounting practice would distribute the total lease expense differently than when accounting according to current practice. While current lease standard prescribes an even distribution of lease expenses over the lease term, accounting according to the ED/2010/9 would make the lease related expenses front-end loaded.

6.4.3 Changes in Regard to Disclosure Requirements

In the ED/2010/9 the IASB (2010a) state that a company would be required to disclose quantitative and qualitative information that;

- identifies and explains the amounts recognized in the financial statements arising from leases; and
- describes how leases may affect the amount, timing and uncertainty of the entity’s future cash flows.

According to Deloitte (2010) this would result in a significant change in disclosure requirements, due to a major increase in the required amount of disclosures.
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6.4.3. Examples: Changes in Lessee Accounting and Financial Key Ratios

The examples below illustrate the change in accounting outcome and financial key ratios for leases currently classified as operational leases when capitalized.

As depicted in Example 1, the outcome of applying the proposed model leads to yearly expenses that would differ from current accounting principles. Accounting according to the proposed model would make the yearly expenses higher in the first years, followed by a decrease over the subsequent years. This is instead of being evenly distributed over the lease term. Another significant change in the accounting outcome is that the lessee would recognize an asset and a liability applying the proposed model for a transaction currently, and thus not affecting the lessee’s statement of financial position at all.

Example 1. Changes in Accounting for Operational Leases
Assumptions:
- Currently the lessee would classify the lease as an operational lease in accordance with IAS 17 Leases.
- Annual lease payment (assumes no contingent rentals, residual value guarantee or term option penalties): CU6,000
- Term of lease: 3 years
- Present value (PV) based on lease payments based on incremental borrowing rate: CU15,000
- A right of use asset of CU15,000 and a corresponding lease liability would be recognized at lease commencement

Profit-or-loss analysis

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
</tr>
<tr>
<td>Amortization of right of use asset</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>1,500</td>
<td>1,000</td>
<td>500</td>
<td>3,000</td>
</tr>
<tr>
<td>Proposed expense</td>
<td>6,500</td>
<td>6,000</td>
<td>5,500</td>
<td>18,000</td>
</tr>
<tr>
<td>Current IFRS expense</td>
<td>6,000</td>
<td>6,000</td>
<td>6,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>

Balance sheet analysis

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>End of year 1</th>
<th>End of year 2</th>
<th>End of year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>15,000</td>
<td>10,000</td>
<td>5,000</td>
<td>-</td>
</tr>
<tr>
<td>Lease liability</td>
<td>15,000</td>
<td>10,500</td>
<td>5,500</td>
<td>-</td>
</tr>
</tbody>
</table>

Current IFRS

*No amounts are recognized on the balance sheet under IAS 17 as it is an operational lease.*

(Ernst & Young, 2010)

Figure 6.1 Lessee Accounting: Changes in Accounting for Operational Leases.
Example 2 shows the potential effect of capitalizing operational leases on key financial ratios, clarifying the relationship between recognized assets and liabilities and the measured equity ratio. As displayed in the figure, when operating leases are capitalized, the equity ratio will decrease due to the heightening of assets and liabilities. Sagner (2010) argues that, as the providers of capital use key financial ratios as the basis in credit decisions, deteriorated key financial ratios due to capitalized operating leases may negatively affect the access to capital.

### Example 2. Impact on Equity Ratio

**Assumptions:**
- Currently the lessee would classify the lease as an operational lease in accordance with IAS 17 Leases and therefore no capitalization has been done.
- The ED/2010/9 requires capitalisation of the lease contract.
- When applying the proposed lessee model the assets and liabilities arises:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Equity</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>300</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>400</td>
<td>100</td>
<td>300</td>
</tr>
</tbody>
</table>

**Impact on the equity ratio when applying the model in the ED**

<table>
<thead>
<tr>
<th>Current IFRS</th>
<th>Accounting according to the ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Equity</td>
</tr>
<tr>
<td>300</td>
<td>400</td>
</tr>
<tr>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Equity ratio: 33%  
Equity ratio: 25%

As can see above, the more assets and liabilities recognized relative to equity in the statements of financial positions; the less is the equity ratio.

Providers of financial capital e.g. banks, investors, and shareholders use the information in the company’s financial statements in order to analyze the financial condition of the company. Through financial analysis based on a number of variables and key financial ratios, stakeholders can form an opinion about the company’s performance relatively other companies. Larsson (2008) argues that stakeholders, through analysis based on key financial ratios, can make valid decisions whether to invest in or do business with the company.

The equity ratio displays the proportion of the company’s total investment that has been financed with the shareholders contributions, and is an indicator of the company’s resistance to losses. The more equity relatively the company’s total investments, the greater chance the company has to make it through losses (Larsson, 2008).

To calculate the equity ratio, the shareholders capital is divided with the company’s total investments:

\[
\text{Equity ratio} = \frac{\text{Shareholders equity}}{\text{Total investments}}
\]

Figure 6.2 Lessee Accounting: Impact on Equity Ratio.
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6.4.4 Problems Addressed by the Exposure Draft 2010 Leases

According to the IASB (2010a), there are a multitude of issues covered by the ED/2010/9. Fundamentally, the IASB argues that the ED/2010/9 would address the following issues:

- Users’ need to adjust financial information.
- Preparers’ ability to manipulate financial information.
- The lease definitions noncompliance with the IASB’s CF.

6.4.4.1 Adjustments of Financial Information

Dhaliwal, Lee and Neamtiu (2011) argue that investors have to make adjustments in the presented information to be able to use it for their purposes. This means that investors also consider operational leases to entail significant risks related to the leased asset for the lessee. Accounting according to the ED/2010/9 would reflect assets and liabilities origination from all leases in the statement in financial position. IASB (2010a) argues that this negates the current issue of merely reflecting assets and liabilities that occur from leases that a company classifies as finance lease. Therefore, investors will not have to adjust the financial statements of lessees for the effects of operating leases based on individual estimates.

6.4.4.2 Ability to Manipulate Financial Information

The ability of companies to structure lease transactions to achieve favorable accounting outcomes has historically been possible. The IASB (2010a) argues that the ED/2010/9 would regulate the accounting of major leases and lead to broader comparability of both the statement of financial position and the statement of comprehensive income. This would prevent the possibility of using operating leases in order to improve key financial ratios in favor of the company.

6.4.4.3 The Definitions Compliance with the IASB’s Conceptual Framework

IASB (2010a) argues that the definition of a lease according to the ED/2010/9 is consistent with the IASB’s (2010c) conceptual framework, as opposed to the definition according to the IAS 17. According to IASB (2010a) a right-of-use asset “is a resource controlled by the lessee as a result of entering into the lease (a past event) and from which future economic benefits are expected to flow to the lessee”. Thereby, it meets the definition of an asset in the CF, which is defined as a “resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity” (IASB, 2010c).

Also, when entering into a lease, the IASB (2010a) argues, an obligation to make lease payments arises, which is expected to result in an outflow of economic recourses. The obligation to make lease payments thereby meets the definition of a liability in the CF, which is defined as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits” (IASB, 2010c).
Thus, the new definition results in all contracts defined as a lease being recognized as assets and liabilities in the statement of financial position.

6.4.5 Criticism against the Exposure Draft 2010 Leases

The proposal of the new leasing standard has received extensive criticism from companies currently using leasing as a form of finance and from lessors providing leasing. In addition, the users of the financial statements have expressed concerns relating to the proposals. IASB and FASB (2011) have summarized the concerns in the comment letters in a public document. The major concerns discussed in the document will be presented below.

6.4.5.1 Front-Loading of Expenses

According to IASB and FASB (2011) many respondents commenting on the ED/2010/9 have expressed concerns regarding the front-loading effect that would come as a result of the proposed lessee model. The concerns arising from the recognition and measurement restriction would lead to higher costs recognized at the beginning of the lease term as a result of the proposed distribution of interests and reduction of the outstanding liability.

6.4.5.2 Deteriorated Financial Key Ratios

Concerns regarding the impact of the new leasing standard have been expressed due to the negative effect the ED/2010/9 may have on companies’ access to capital. For companies with a substantial amount of operating leases, the proposal will cause a significant increase in recognized assets and liabilities. As a result the IASB and the FASB (2011) state that several of the companies’ key financial ratios, (e.g. leverage and capital ratios) will deteriorate because of the rise in reported debt financing. Grossman and Grossman (2010) argue that the deteriorated key financial ratios may lead to changed borrowing covenants and thereby impact the access to financing. Beatty, Liao and Weber (2010) on the other hand, argue that the importance of accounting quality decreases as the banks willingness to be more accurate in valuation increases.

6.4.5.3 Undue Costs

The IASB and the FASB (2011) clarifies that the ED/2010/9 has also been criticized due to the various costs imposed by the new accounting standard. Beattie, Goodacre and Thomson (2001) show in their study, consistent with the views of the preparers, the increased cost resulting from the capitalization of operating leases. In their research examining the impact of capitalizing operating leases, Beattie, Goodacre and Thomson show that the changed requirements of lease accounting might impose additional compliance and administrative costs for the preparers, primarily for small companies. For instance, the IASB and the FASB (2011) explains that the implementation of the new standard will require companies to evaluate numerous contracts in order to determine whether they meet the new definition of a lease or not. In addition, the proposal will also incur costs due to the required change in controlling and processing the adjusted IT systems. Watts and Zimmerman (1978) argue that costs will arise at the implementation of a new accounting standard, thus. There are however exceptions. For example, current
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accounting methods are so complex that simplifications with the proposed standard immediately would result in cost benefits.

6.4.5.4 Changed Business Behavior

A further potential drawback of the proposed accounting standard relates to the risk of changed business behavior. In comment letters to the IASB and the FASB (2011), respondents have expressed concern with the perceived high costs of implementing and obtaining the proposal and the possible effects these might have on the leasing industry. This concern is supported by the research of Marriott and Marriott (2010), examining the possible effects of the new leasing standard in the UK market. Their study shows that the impact of the cost imposed by the proposals may lead to changed business behavior that would negatively affect the leasing market. Because of the reduced benefits of leasing, there is a risk that companies will choose to purchase rather than lease the asset. This would potentially result in a decreasing leasing market.

6.4.5.5 Information Usefulness

The ED/2010/9 aims to improve financial reporting through the recognition of all assets and liabilities arising from lease contracts on the statement of financial position. However, the objective of improving the information provided to the users of the financial statement has been somewhat questioned.

As mentioned in in the introduction, the proposed leasing standard would limit previously possible subjective judgments in the classification of finance and operational leasing. Thus, it has been argued that the ED/2010/9 creates opportunities for new subjective assessments when it comes to estimating the lease term and the calculation of variable lease payment (IASB and FASB, 2011).

Furthermore, the new leasing standard seeks to increase transparency so that investors will not need to adjust for operating leases. Hence, according to the IASB and the FASB (2011), there are users of the financial statements claiming that they will continue to do adjustments regardless of the new standard.

6.5 Usefulness of Financial Information

Due to the main issues regarding the replacement of the ED/2010/9 this study focuses primarily on the usefulness of produced financial information. The main purpose of the IASB’s development of a core set of accounting standards is to endorse high usefulness of the produced financial information. However, a large proportion of the criticism addressed to the process is concerning the information’s usefulness. Such as, one of the key arguments against the ED/2010/9 is that the new standard would lead to decreased faithful representation. Meanwhile, the IASB claim that the new standard would lead to improved comparability.

In the CF the IASB (2010b) presents six qualitative characteristics of useful information. These characteristics identify information that is likely to be most useful for the users of financial statements.

The IASB (2010c) divides the qualitative characteristics of useful financial information into fundamental qualitative characteristics and enhancing qualitative
characteristics. The fundamental qualitative characteristics are the most critical qualitative characteristics. The enhancing qualitative characteristics are less critical for the usefulness but still highly desirable. According to the IASB (2010b) information is useful if it is relevant and faithfully represented. The information is enhanced if the information also is comparable, verifiable, timely and understandable.

Although all qualitative characteristics are important for the usefulness of financial information this study is primarily concentrated with the two characteristics discussed in relation to the change of lessee accounting standard; faithful representation and comparability. Therefore, the following text will concentrate on these two qualitative characteristics.

6.5.1. Faithful Representation

IASB (2010a) argues that information is faithfully represented if it has the following characteristics; complete, neutral and free from errors. Information is complete if it provides the users with all information needed to understand the phenomenon being depicted, including all descriptions and explanations. A neutral depiction is a depiction without bias in the selection of included information or in the presentation. This means that the information cannot be slanted, weighted, emphasized, de-emphasized or otherwise manipulated. The meaning of free from error is that the information contains no errors or omissions about the depicted phenomenon.

However, Deegan and Unerman (2011) question the Board’s objective with neutral and representational faithfulness. They say it might be neither valid nor realistic to expect financial accounting to give an objective view of a company’s performance. Before an accounting standard-setter changes the accounting principles it has to consider the economic consequences that would follow from the change. The result is that plans can be abandoned because of extensive costs, even if the proposed accounting would be the best way to account. There are also theories stating that the management, responsible for the financial reporting, is self-driven and always choose accounting methods that result in outcomes that are favorable to their own personal wealth.

Another aspect that Deegan and Unerman argue is affecting the neutrality of the financial information is the political aspect. Changes in accounting principles are developed through public consultation, and if the changes would result in negative consequences for preparers of financial information, they will try to make standard-setters modify their positions.

6.5.2. Comparability

The CF states that useful financial information is most useful if it can be compared with similar information (IASB 2010b). Comparability is an important aspect when users evaluate a company’s financial statement and development. For the users to be able to get an idea about the company’s performance relative to other companies its financial statements must be comparable with similar information from the others.

Characteristics such as consistency, are according to the IASB (2010b) a desirable aspect related to achieve comparability. Although, Deegan and Unerman (2011) argue that a restriction in the amount of accounting information, which normally is the way to achieve consistency, can compromise the efficiency of financial information. For example, management might choose a method they believe gives the best reflection of the
company’s performances. However, restricting the use of accounting methods can affect the users monitoring of the company’s performances.

Deegan and Underman (2011) argue that, according to the efficiency perspective, companies will adopt the particular accounting methods that form the best picture of the company’s performances. Meanwhile, other theorists argue that regulation of accounting causes undue costs. Because of that the best way to achieve comparability might be to let managers select the most appropriate accounting methods, while government and others should not intervene.

6.6 Theoretical Approaches

According to the American Accounting Association (1975 in Riahi-Belkaoui, 2000) decision usefulness of financial information can be described in relation to the decision-maker responses. That is, in a behavioral accounting and market level approach.

One perspective on decision usefulness is the decision-usefulness/decision-maker paradigm, described by Gonedes (1972 in Riahi-Belkaoui, 2000). This states that market response to a company’s financial information is the governing factor for producing financial information and developing the procedures used to produce it. Thus, Gonedes work focuses on the aggregated-market response and is an extension of prior science based on decision usefulness in relation to the individual-user’s response.

According to Riahi-Belkaoui (2000) those who adopt the decision-usefulness/decision-maker paradigm focuses on the aggregate-market response to presented financial information primarily based on the theory of the efficient market.

6.6.1 The Efficient Market Approach

According to Shleifer (2003) the efficient market hypothesis (EMH) has been the central statement of finance for many years. According to the EMH a market is efficient if it quickly and accurately reflects new information available on the market. Fama (1970 in Kam, 1990) argues that the EMH comprises three forms of efficiency based on which information affecting the market prices; weak, semi-strong and strong form of market.

- A weak form of market only reflects historic information.
- A semi-strong form of market reflects all public information available in the market.
- A strong form of market reflects both public and private information.

Schallheim (1994) discuss the efficient market theory based on a perfect market view. In a perfect market there are no taxes, no costs for transactions, inflation or brokerage and no single investor can affect the market prices. Due to this approach, the only information that should affect the market prices in the efficient market is information related to solid economic changes or differences.

Thus, based on the perfect market position the only reasons to favor or disfavor different financing types are solid economic reasons that should be affecting the market prices. Solid economic reasons are reasons that are based on violations of the perfect capital market statement.
6.6.2 The Inefficient Market Approach

Kam (1990) argues that there is an alternative to the EMH, stating that the securities market is inefficient (Goodacre, 2002). That position implies that investors cannot interpret all new information accurately. The consequence is that the investors can be misled and confused by the accounting methods being used and by the presented numbers. On a related note, Taylor and Turley (1985 in Goodacre, 2002) argue that managers in their decision-making assume that the market is inefficient in processing the information. Based on this approach Schallheim (1994) argues that market prices can be affected not only by solid economic reasons but also by investor sentiment and psychology.

6.7 Summary

The proposed lease accounting model would lead to significant changes in the accounting principles for lessees. The main proposal in the ED/2010/9 is that lessees would apply a right-of-use model, instead of risks and rewards, for lease accounting. This would result in all leases affecting the lessee’s statement of financial position. As a result of the change operating leases would no longer be an accounting option, which is the reason to why the most significant impact would affect lessees that today have a substantial portfolio of operating leases.

For leases currently recognized as operating leases the rent expense would be replaced by asset amortization and interest expense. For leases currently classified as financial leases, the impact would be less fundamental, primarily related to the measurement of the asset and the liability arising from the lease contract.

The IASB (2010a) argues that the ED/2010/9 would address a multitude of issues in the current lease standard. For example, accounting according to the model in the ED/2010/9 would result in all assets and liabilities recognized in the lessee’s statement of financial position. The IASB also argues that the proposed model would lead to better comparability and provide further consistency with the CF.

However, the proposed model has received extensive critic from both lessees and lessors. The major concerns regarding the proposed lease accounting model is its potential effect on the lessee’s loan covenants, changes in the business behavior by the lessees and that the model would not reflect the lessee’s financial activities.

The Board’s and the preparer’s conflictive opinions regarding the proposed lessee model are related to the usefulness of financial information produced when applying the model. Mainly, the concerns relates to the qualitative characteristics of faithful representation and comparability.

Faithful representation implies that the presented information should depict what it is intended to. According to the Board (IASB, 2010b), information is faithfully represented if it is complete, neutral and free from error. Nevertheless, there are several theorists that object to that standing by questioning if it is realistic to expect financial information to give a faithful depiction of a company’s performances.

Comparability is a qualitative characteristic subordinated to faithful representation, but still highly desirable for achieving useful financial information. Comparability is the quality that makes it possible for the users to compare the financial information of a company with other companies or with the individual company’s financial information.
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from different years. According to the Board, consistency is an aspect that helps achieve comparability. However, there are theorists arguing that consistency impairs the usefulness of financial information and that the best method might be to let the managers choose valuation methods without interventions by governments and others.

Usefulness of financial information can be described in relation to behavioral and market theories. For example, the EMH states that an efficient market reflects information quickly and accurately. Theorists that base their opinions on the perfect market state that only solid economic reasons should affect the market. However, theorists that do not agree of the perfect market approach argue that even investor sentiment and psychology can have influence of the market.

6.8 Analysis and Discussion

In the following section, the study’s main issues will be processed in relation to the above presented criteria for useful information and theoretical approaches. The section is divided into two main parts; “Lessees’ Behavior” and “Users of Financial Information”. In the first part the expected changes as a result from implementing the ED/2010/9 will be processed based on a company perspective. In the second part, the changes will be processed based on a user perspective. The division is made because of the conflict of opinion that seems to exist between companies and users, based on the critic presented in previous sections, in regard to the change.

6.8.1 Lessees’ Behavior

Preparers of financial statements argue that the proposed lease model would potentially lead to companies choosing to finance investments through borrowing rather than through lease financing. The main argument is that the new standard would prevent the current possibility of using off-balance-sheet accounting.

The change is likely to affect companies that choose to meet their investment needs through operating leases. Thus, the debate originates with management no longer being able to have an influence on the lease’s impact on capital structure. For this argument to be considered valid, it is required that market prices can be affected by investor sentiment and psychology, due to the only difference being how the transaction is presented to the user of the information.

However, the change will affect key financial ratios that depend on the debt to equity ratio, e.g. solvency and return measurements. Consequently, this might lead to difficulties in obtaining financing and an increase in the capital cost of borrowed capital. For this to be considered a valid economic reason, an assumption that banks and other lenders cannot see the underlying causes of the changed key ratios is required. Therefore, it is understood that the lending institutions’ decisions are influenced solely by the accounting change. Thus, this argument is not entirely in line with the perfect-market view.

In order to determine the impact that the new lease standard has on the cost of borrowed capital and companies’ access to financing, an understanding of the extent to which pure accounting changes affect banks and other lenders is required.

Beatty, Liao and Weber (2010) argue that the importance of accounting quality decreases when banks are willing to be more accurate in company valuation decisions. On the basis of this reasoning, it can be assumed that if banks and other lenders are
Emelie Bojmar and Malin Petersson

willing to have communication with the company and be more accurate in valuing the company, the change should not result in any major differences regarding capital cost and obtaining capital.

Furthermore, it can be assumed that shareholders have more limited opportunities, relative to banks and other credit providers, to communicate with companies. Thus, their information is more confined to the scope of information presented in the financial statements. Based on the assumption of efficient markets, it can be argued that the proposed model will not result in an improvement of the financial information due to the fact that the information is already available in the notes. Nevertheless, according to Goodacre (2002) there is empirical evidence proving the inefficiency of the market, thereby highlighting the importance of the way information is presented. For investment decisions not to be affected by deteriorated key ratios as a result of changed accounting methods, it is therefore required that companies present information in a clear and understandable manner. If the company provides investors with detailed information, shareholders can better assimilate the information and understand that the changes are solely due to the information being presented in a different way.

The question that arises is therefore, whether shareholders, banks and other lenders are willing to examine the financial statements with this level of accuracy. The IASB’s conceptual framework states that users of financial information must have a basic understanding of economic activities and be willing to review the information with reasonable diligence. The definition of reasonable diligence is not explained in further detail. However, it can be concluded that the more simplified the presentation of the information, the easier it is for stakeholders to assimilate the information and understand the changes.

Although companies attempt to make necessary information accessible to its stakeholders, it is not possible to escape the fact that there is a risk that the changes will lead to negative reactions on the market, at least in the short term. In the long term, stakeholders can obtain adequate knowledge of companies’ lease accounting, thus enabling them to take more valid decisions. This is provided that companies produce sufficient information.

Irrespective of the market’s actual efficiency in processing the information, there is strong evidence that managers, in their decision-making, assume that the market is inefficient (Taylor and Turley, 1985 in Goodacre, 2002). If companies act on the basis that their stakeholders’ investment decisions will be affected by the new lease standard, it is likely that they can seek financing elsewhere. It is therefore not possible to reject the logic that the lease market may be adversely affected by the implementation of the standard. However, there are several advantages of leasing in addition to the possibility of off-balance-sheet accounting. The new standard does not reduce contractual freedom in the preparation of lease agreements, therefore allowing companies to create lease agreements that bring significant benefits to the company. Leases will still be flexible in terms of the lease period and lease payments. This brings tax benefits to companies, while also allowing the lessee to avoid risks associated with the underlying asset.

This changed business behavior is likely to only apply to lessees whom have a high proportion of operating leases. For finance leases, the new standard does not pose any major changes regarding the approach in reporting. The fact that companies choose to establish lease agreements that result in finance leases, which do not result in off-balance-sheet accounting, further suggests that there are more significant advantages to leasing.
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In addition to the potential higher cost of financing, preparers of the financial information have also expressed concerns related to the implementation costs. As opposed to the potential increased cost of capital, implementation costs do not depend on how they are perceived by the company’s stakeholders. That is, the implementation costs are not associated with the way lenders or investors interpret financial information. Therefore, implementation costs can be assumed to arise irrespective of the level of market efficiency.

However, if IASB is to achieve their goal of providing useful financial information, it can be assumed that it is in their best interest to keep implementation costs to a minimum. This is due to the aspect of political interference that can affect the implementation of a new accounting standard if the costs are determined to be too high.

6.8.2 Users of Financial Information

As mentioned above, the new lease standard would cause changes in lessees’ financial key ratios. It is also stated that this change potentially would affect investing decisions of banks and other stakeholders. The change would generally result in deteriorated solvency and return measurements, which means impairment for the lessees. However, from an investor perspective it would be relevant to study which accounting method give the most useful information in regard to the underlying transactions.

The classification between operational and finance lease is based on risks and rewards related to the ownership of the leased asset. Dhaliwal, Lee and Neamtiu (2011) argue that users of financial information consider the lessee standing for significant risks related to the leased asset also when the agreement is classified as operational. Because of the lack in reflecting the correct distribution of risks between lessees and lessors, users have to make adjustments to be able to use the information. By implementing the ED/2010/9 the IASB (2010a) argues that the problem would be solved and investors would be able to use the lessees’ financial information without adjustments. However, critics of the ED/2010/9 argue that some leases are operational by nature and should not be reflected in the lessee’s balance sheet. Due to this argument the ED/2010/9 could not give a correct depiction of these transactions. If this is the case, the result would likely be that investors also continue to make adjustments after implementation of the ED/2010/9.

Hepp and Scoles (2012) agree about the considerable weaknesses in current lease standard. However they do not agree completely with the IASB’s solution to the problem. Instead they argue that there are two possible solutions dependent on what is considered the problem. If the problem is considered to be the classification between operational and finance leases then IASB’s solution to develop one single accounting model is accurate. However, if the problem is considered to be that the lessees abuse the explicit criteria in IAS 17, a better solution would be to modify the criteria.

If the problem is considered to be the separation of operational and finance leases, the ED/2010/9 would probably provide the users of financial information with more useful information addressing that the information is more accurately depicted. To claim that the ED/2010/9 would result in a more accurate depiction of lease transactions, first one must accept that the IASB’s right-of-use approach is a more accurate basic assumption when identifying a lease than the current risks-and-rewards approach.

Accepting the IASB’s right-of-use-approach all lease agreements represent assets and liabilities in form of the usufruct of the underlying asset and the obligation to make lease future lease payments. In this case the most accurate depiction of the contract would
be to recognize it in the lessees’ balance sheet. If the right-of-use approach is not accepted and instead the basis is considered to be risks and rewards related to the leased asset, then some leases might not be considered to entail sufficient risks and rewards to give an accurate depiction when recognized in the lessees balance sheet.

If the problem is considered to be that the lessees modify their lease agreements to get the desired accounting effect, the basic assumption probably is the risks-and-rewards approach. Due to this, the ED/2010/9 would not likely give an accurate depiction of the lessees’ lease activities. A better solution in this case might be to modify the criteria instead of developing one single accounting model.

As mentioned, by implementing the ED/2010/9 the lessees’ influence on the lease agreements’ effects of its financial statements would decrease. With elimination of the classification between finance and operational leases all lease agreements would be recognized in the same way. Due to that Deegan and Unerman (2011) argue that the company management is driven by the company management’s self-interest. Thus it is possible that they, when accounting according to IAS 17, try to manipulate the lease agreements effect in the financial statement. Therefore, it is likely that implementation of ED/2010/9 would improve the neutrality of lessees’ financial information.

Based on the IASB’s (2010b) reasoning of consistency as an improvement of comparability, it is possible that elimination of accounting alternatives increases the comparability of the lessees’ financial information. However, Deegan and Unerman (2011) argue that consistency might compromise the information efficiency. For this to be the case however, the basic assumption would be that the management strives for the most accurate depiction of the underlying transaction when accounting. Due to the argumentation that the management’s strive for what is best for the company faithful representation is not likely to be the management’s highest priority when making accounting decisions. Critics arguing that one of the major problems with current accounting standard is abuse of the explicit criteria further reinforce this assumption.

For lessees that currently have a significant amount of operational leases recognized, implementation of the ED/2010/9 would result in earlier recognition of expenses. Critics of the ED/2010/9 argue that this would result in a decreased faithful representation of the lessees’ lease activities. However, whether the ED/2010/9 provides a less accurate depiction of lease activities or not, is dependent on whether the lease agreement is considered to be similar to a debt financed purchase or a rental agreement. If the economic substance is considered to be equal to a debt-financed purchase the ED/2010/9 provides a good depiction of the transaction. If the economic substance instead is considered to be equal to a rental agreement, the representation might be more faithful if the recognized cost is determined to the lease payments being made during the current accounting period.

6.9 Conclusions

It is primarily companies with a significant amount of operating leases recognized that would be affected by implementing the ED72010/9. Likely, implementing the ED/2010/9 would not bring any significant advantages for the companies. The change would rather result in disadvantages for companies due to additional implementation costs and elimination of the ability to obtain off-balance sheet financing through lease contracts.
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However, in regard to usefulness of the companies’ financial information the implementation of the ED/2010/9 would probably result in significant advantages.

The most significant disadvantage, expressed by companies, is a deceased ability for company management to influence the company’s financial position through lease contracts. Whether the critic against the ED/2010/9 is valid or not depends on banks’, investors’ and other stakeholders’ willingness and ability to accurately evaluate the company. That is, if banks, investors and other stakeholders can see through and understand the reason for the change, it would not likely result in any major disadvantages such as increased capital costs.

The most common opinions, in regard to usefulness of financial information when accounting according to the ED/2010/9, is that it might provide a more faithful representation. However there are some theorists that argue that analysts would have to adjust the information, when evaluating companies, even after implementation of the ED/2010/9. Whether the ED/2010/9 would result in a more faithful representation of financial information or not depends on what approach is considered the most appropriate when accounting for leases. If the current risks-and-rewards approach is considered to be the most appropriate basis for lease accounting, the ED/2010/9 would not likely improve the representation faithfulness. If the new right-of-use approach is considered the most appropriate, the faithfulness of financial information would probably be improved.

In regard to the effect on information comparability, restriction of accounting alternatives would probably result in an improvement; due to the company managements’ striving to meet their own self-interests rather than improving the usefulness of financial information.

**6.10 Questions**

- Does the proposed right-of-use approach make a more appropriate basis for lease accounting than the current risk-and-rewards approach?

- What amount of disclosures is required for a faithful representation of a company’s lease activities;
  - when accounting according to IAS 17?
  - when accounting according to the proposed model in ED/2010/9?

- What amount of accuracy can be expected from banks respectively investors and other stakeholders when evaluating a company?
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Internet

Chapter 7
Hedge Accounting - Simplified with new rules?

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Linus Lindholm
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7.1 Introduction

Today it is very common for companies to engage in international trade in order to increase their sales. In 2011 the value of world merchandize trade was 18.2 trillion dollars (WTO, 2012a). International trade is not a new phenomenon although it has grown rapidly over the last decades (WTO, 2012b). This growth has not only increased the profit but also increased the risk exposure of companies. Differences in exchange rates and inflation could change a profitable sale into a loss. In order to manage the risk associated with international trade, companies use hedges. Hedges are investment options designed to offset potential losses or gains on underlying assets caused by risk. Companies using equity to fund their businesses usually wish to disclose as much information as possible in order to attract investors. Hedge accounting is a method to visualize the risk management relationships companies construct between items connected with risk and the hedging instrument.

International Accounting Standards (IAS) 32 and 39 are standards issued by the International Accounting Standards Board (IASB). The standards partly treat hedge accounting, however IAS 39 has been criticized for being too rule-based and complex. Doupnik and Perera (2012) have pointed out that hedges might not be shown accurately in the company’s financial statements as a result of this. However, the development of standards has progressed over the years and the IASB’s plan is to release a new standard in 2015, International Financial Reporting Standard (IFRS) 9. The standard will replace the current IAS 39. Falkman (2010) describes the aim of IFRS 9 to be that of a more principles-based standard, that is supposed to reduce complexity hence leading to the accounting more accurately reflecting the risk management relationship.

The purpose of this chapter is to provide the reader an understanding of hedge accounting before and after the change to IFRS 9 and to discuss whether a move to a principles-based standard better reflects the risk management activities of companies.

The success of the new standard is dependent on it being perceived as less complex and restricting. Therefore we ask:

• What is the perception of the new standard among standard setters and preparers of financial statements?
• In what manner does IFRS 9 better reflect risk management activities of companies?
After reading this chapter, you should be able to:

- Understand the accounting procedure behind hedge accounting, both according to IAS 39 and IFRS 9.
- Describe the differences between IAS 39 and IFRS 9.
- Have an insight on how the new standard is perceived among standard setters and preparers of financial statements.

7.2 Disposition
This chapter is divided into four major parts. The first part focuses on IAS 39 and aims to briefly explain financial instruments and hedge accounting under the standard. The second part looks ahead at how hedging and hedge accounting will be treated under IFRS 9. It also features a summary of the major changes between IAS 39 and IFRS 9. The third and fourth parts consist of a discussion and subsequent conclusions.

7.3 Definitions

<table>
<thead>
<tr>
<th>Financial instrument</th>
<th>Is defined in IAS 32 as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivatives</td>
<td>The generic name for financial instruments whose value is linked to another instrument.</td>
</tr>
<tr>
<td>Hedged item</td>
<td>The asset or liability that creates the risk that needs to be managed.</td>
</tr>
<tr>
<td>Hedging instrument</td>
<td>The asset or liability being used to minimize the risk caused by the hedged item.</td>
</tr>
<tr>
<td>Spot exchange rate</td>
<td>The rate at which a bank agrees to exchange one currency to another.</td>
</tr>
<tr>
<td>Forward exchange rate</td>
<td>The rate at which a bank agrees to exchange one currency to another at a future date.</td>
</tr>
</tbody>
</table>

Figure 7.1 Definitions

7.4 Hedging
Hedging is used to reduce companies’ risk exposure with the use of financial instruments such as derivatives. Hillier et al. (2010) define companies’ trade with derivatives without the aim to reduce risk as speculating. Hedge accounting, which will be explained in greater detail in following sections, is thought to show a company’s intentions with their trade of financial instruments and clarify when they are not engaged in speculation.
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Hedging differs from insuring because, as Bodie et al. (2009) explain, it involves giving up the potential for gain to eliminate the risk of a loss. With the help of a forward contract, or by purchasing options, a company can eliminate the uncertainty that can arise from foreign trade. This can make the exchange rate known at the time of the sale or purchase even if the payment takes place later in time. It is the time between an agreement to either sell or purchase goods and the actual payment that causes uncertainty. Doupnik and Perera (2012) explain that the fluctuating exchange rates will give rise to either a gain or a loss when the payment is made and that the difference in the journal entries has to be accounted for.

Bodie et al. (2009) also show that hedging can be used to protect companies from other types of risks. Fluctuating interest rates or changes in commodity prices are both common sources of uncertainty for companies. This chapter however, will focus on risk caused by foreign exchange rates. The following sections explain what qualifies as instruments and items according to the standard.

7.5 IAS 39

The International Accounting Standards Committee (IASC), the predecessor to the IASB, published IAS 39, Financial Instruments: Recognition and Measurement, in December 1998 (Deloite, n.d). The American Accounting Association (AAA, 1998) set IAS 39 as one of the IASC’s ‘core standards’ and it was urgent to complete the standard in order to allow the International Organization of Securities Commissions (IOSCO) to consider whether they would endorse the standards or not. The IASC recognized that there was still work to be done in the area of financial instruments (ibid). Since then, several amendments and revisions have been done to improve the standard (IASB, 2012b). The latest version of IAS 39 will serve as basis in this section.

7.5.1 Financial Instruments

Doupnik and Perera (2012) give some examples of financial assets such as receivables, loans made to other entities, investment in bonds and equity instruments in other entities. Further they describe that payables, loans from other entities or issued bonds are common examples of financial liabilities. A group of financial instruments often used for speculation and hedging risks are classified as derivatives. Financial instruments that are not included in this category are called non-derivatives or primary instruments in the following text.

7.5.4 Hedging Instruments

According to IAS 39, both derivatives and non-derivatives can be used as hedging instruments. In the first category some restrictions exist regarding options. One example of this is written options. The reason given in the standard is that they can be ineffective as a hedge because of the possibility of a loss greater than the gain in value of the hedged item. The rules also allow non-derivatives as hedge instruments as long as the risk related to the item is caused by currency exchange rates (IASB, 2012b).

A difference between the two categories is that derivatives also can be used to hedge other types of risk. There are several ways to use financial instruments for risk
management. The standard allows a combination of two or more derivatives as one hedge for a single item. Another possibility is that more than one type of risk needs to be hedged by one single instrument. Three conditions need to be met for this to be in line with the standard (ibid):

- Clearly identifiable risks;
- Clearly identifiable relationships between the hedging instrument and the individual risks; and
- Proven effectiveness of the hedge

Another possibility in IAS 39 is to use only a proportion of an instrument, for example 50% of its value, in a hedging relationship. It is not allowed however, to construct a hedging relationship between an item and a proportion of the time period during which a hedging instrument remains outstanding. Dividing an instrument based on different sources of value is prohibited as well (IASB, 2012b).

The standard also states that the relationship with the item has to be based on the instruments entirety, except for two situations where parts can be valued separately without problems. The exceptions are (ibid):

- when only the intrinsic value, and not the time value, of an option is designated as a hedging instrument; and
- a separation between the interest element and the spot price of a forward contract

When companies within a group enter into hedging transactions with each other the values are usually eliminated in the consolidated statements. Therefore, in-group accounting, hedging instruments have been restricted to agreements with external parties (IASB, 2012b).

The most common hedging instruments are forward contracts and options. According to Bodie et al. (2009), this is a common type of agreement between two parts. They explain how it regulates a future exchange of, for example, goods, services or currency at a price specified now. This is called the forward price and it eliminates the uncertainty that comes with a fluctuating spot price. Forwards involve no payments at the time of an agreement and the face value of the contract is the quantity of the underlying item times the forward price. Even though one uncertainty has been eliminated, as Bodie et al. (2009) point out, both parties are involved in a speculation of what the future spot price will be. As a result of this, the forward contract will give rise to a profit or a loss at the delivery date. We are going to use forward contracts to hedge against risks in 1.5.6.

7.5.5 Hedged Items

In hedge accounting several different types of items can be part of a hedging relationship. IAS 39 includes recognized assets and liabilities as well as unrecognized firm commitments (IASB, 2012b). A forecasted transaction or foreign net investment can be approved as an item provided that it is highly probable. An example of a recognized asset
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is when company A sells and delivers cars to company B on one date and allowing that company six months to pay. The account receivable is then a recognized asset that can be hedged. Had the contract stated that company A also had six months to deliver the cars, it would instead have given rise to a firm commitment. A forecasted transaction is explained by Doupnik and Perera (2012) as when the company forecasts that it will make a business transaction with another company.

According to IAS 39 a hedged item can also be derived from a group of the factors mentioned above as long as the risk affecting them is similar. The rules described earlier, regarding instruments being limited to agreements with external parties in consolidated statements, also apply for hedging items. An exception can be made when, for example, a debt between two subsidiaries has the potential to cause a foreign exchange loss that is not eliminated in the consolidated financial statements (IASB, 2012b).

It is in line with IAS 39 for assets and liabilities to be collectively designated as an item provided that the same type of risk equally affects them. An item can also consist of only a portion of an asset or liability if the effectiveness of the hedge can be measured. When the item is a non-financial asset or liability the risk involved should be viewed in its entirety because of the difficulty involved in separately measuring different types of risk. It is possible though, to separate currency risk as a hedged item (ibid).

7.5.6 Hedge Accounting

This section aims to provide an understanding of the mechanics in hedge accounting; how to define, assess and account for different hedges.

IASB (2010b) defines hedge accounting as a mechanism to reflect some risk management activities, allowing the links between hedging instruments and hedged items to be visible to the users of the financial statements.

Doupnik and Perera (2012) describe how hedge accounting is used as a way to recognize the gain or loss from the hedging instrument in the same period as the gain or loss from the hedged item. This is, according to PwC (2005), a departure from normal accounting procedure. Normal accounting procedure may otherwise demand gains or losses to be recognized in the same period as they arise, causing volatility in profit and loss. For example, ideally one loss of USD 1,000 on an account receivable (a hedged item) is totally offset by a gain of USD 1,000 on a forward contract (a hedging instrument). This gives an effectiveness of 100 %. The gain and loss can then be recognized in the same period, cancelling any volatility in profit and loss. Hedge effectiveness and how it affects hedge accounting will be discussed later in this section.

IASB (2012b) has in IAS 39 p. 86 listed different types of hedging relationships. The hedging relationship determines how the hedge should be accounted for (ibid). The two major hedging relationships are:

• ‘Fair value hedges’ are hedges of exposure to changes in fair value caused by certain risks. The risk must have the possibility to affect profit and loss if not hedged.

• ‘Cash flow hedges’ limit the variability of cash flows caused by a certain risk or variability in cash flow that could affect profit or loss.
The classifications in IAS 39 p. 86 result in the possibility to classify a certain hedge as either a fair value or a cash flow hedge. PwC (2005) comments how hedges of firm commitments may be classified as both, as the risk affects the fair value of the commitment and the future cash flow. If no hedging relationship is defined, it will be defined as a fair value hedge by default (Douplik and Perera, 2012). Figure 7.2 shows how a company involved in business with a foreign company chooses to define a hedge. The example will be used throughout the chapter.

### Defining the hedging relationship

Company A is a U.S. engine manufacturer. The functional currency is U.S. Dollar (USD). Balance sheet date is 31 December.

On 1 September 2006, the company ships 1,000 engine parts at a price of EUR 3,000 per engine to company B in the Netherlands. A total payment of EUR 3m is due on 1 March 2007. This gives rise to an account receivable and can be classified as a recognized asset.

On 1 September, company A decides to hedge the foreign currency risk arising from the contract. The risk arises, as there is a possibility of a depreciation of the USD against the EUR. This will cause a foreign currency loss and may turn an otherwise profitable transaction into a loss. The company decides the best hedging instrument is a forward contract to sell EUR 3m and instead receive USD on 1 March 2007.

The first thing company A needs to do in order to use hedge accounting is to define the hedging relationship. It can choose to use a cash flow hedge or a fair value hedge, as the foreign currency risk has the possibility to affect both the fair value of the account receivable and the forecasted cash flow.

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**Figure 7.2 Defining the hedging relationship**

The defined relationship is eligible for hedge accounting if all of the conditions in IAS 39 p. 88 are met (IASB, 2012b). These conditions state that there has to be a formal designation and documentation of the relationship and the company’s risk management objective (ibid). In other words, the hedging relationship must be made visible from the start. Another condition in the standard is that the hedge must be expected to be highly effective and the company has to document how it will go about assessing the effectiveness.

This subsection describes hedge effectiveness assessment, ineffectiveness and the discontinuation of hedges that are no longer deemed to be effective. IAS 39 p. 88 requires a hedge to be highly effective. A hedge is highly effective if the change in fair value on the hedging instrument offsets the changes in fair value of the hedged item (IASB, 2012b). IASB (2012b) demands two assessments. One is measuring whether the hedge is expected to be effective in future periods and the other one is looking backwards, examining if the hedge has been effective in the past period. PwC (2005) uses the words prospective and retrospective effectiveness tests to describe these two assessments. These definitions will be used throughout the chapter. IASB (2012b) requires the prospective test to be done both at the inception of the hedge as well as when preparing interim or annual financial statements. The retrospective test must be undertaken when preparing the financial statements.

IAS 39 AG105 states that the hedge must be assessed to be highly effective both according to the prospective and the retrospective test. The prospective test is centered on expectations of high effectiveness. IASB (2012b) says that such expectations can be
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based on a comparison between past changes in value on the hedged item and in the value of the hedged instrument. Another measurement option described is to demonstrate a high statistical correlation between the value of the hedged item and the instrument.

AG105 (b) contains a method for the retrospective assessment (IASB, 2012b). PwC (2005) calls this method ‘the dollar offset method’, while Ernst & Young (2011a) refers to the method as a ‘bright line test’. AG105 requires the actual change in value on the hedging instrument to be within 80-125 per cent of the change in fair value on the hedged item (IASB 2012b). IASB (2012b) exemplifies the retrospective test in AG105 (b): “…if actual results are such that the loss on the hedging instrument is 120 and the gain on the cash instrument is 100, offset can be measured by 120/100, which is 120 per cent…” As the result is 120 per cent, the hedged has been highly effective.

According to PwC (2005), the prospective effectiveness test can be done using either a numerical test or by comparing the critical terms of the hedge. The hedge is deemed to be highly effective if all critical terms match each other perfectly (ibid). This is illustrated in figure 1.2.

### Prospective effectiveness test

The prospective effectiveness test can be done by comparing the critical terms of the hedge. This is the prospective effectiveness test on the hedge defined in figure 1.1.

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Hedging instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Account receivable</td>
<td>Forward contract</td>
</tr>
<tr>
<td>Receive EUR 3m</td>
<td>Sell EUR 3m</td>
</tr>
<tr>
<td>Matures 1 March 2007</td>
<td>Matures 1 March 2007</td>
</tr>
<tr>
<td>Depends on EUR/USD exchange rate</td>
<td>Depends on EUR/USD exchange rate</td>
</tr>
</tbody>
</table>

As all terms match each other, the hedge is deemed to be highly effective and no quantitative test is necessary. The prospective test is done at the inception of the hedge and at the balance sheet date.

Figure 7.3 Prospective effectiveness test

Aside from measuring hedge effectiveness, IASB (2012b) also requires the measurement of hedge ineffectiveness. IAS 39 AG114 defines hedge ineffectiveness as the difference between the change in fair value of the hedged item and of the hedging instrument (ibid). PwC (2005) writes that ineffectiveness can normally arise when the item and the instrument are expressed in different currencies or use different underlying interest indices. IAS 39 p. 96 only recognizes hedge ineffectiveness when the hedge is defined as a cash flow hedge and the change in the instrument is greater than the change in the hedged item (IASB, 2012b). According to p. 89, there is no recognition of hedge ineffectiveness if the hedge is a fair value hedge.
Hedge ineffectiveness

Company Z has a cash flow hedge. The hedged item is a foreign denominated account receivable and the hedging instrument is a forward contract. Due to movement in the foreign exchange rates, their fair value change as follows:

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Hedging instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>- 1,000</td>
<td>+ 1,100</td>
</tr>
</tbody>
</table>

The hedge ineffectiveness is the change in fair value on the hedging instrument that exceeds the change in fair value on the hedged item. In this case, 100 are recognized as hedge ineffectiveness.

Figure 7.4. Hedge ineffectiveness

IAS 39 p. 88 required hedges to be highly effective in order for hedge accounting to be allowed. What if, after a period of time, the hedge is assessed to not be highly effective? IASB (2012b) regulates the discontinuation of hedging in IAS 39 p. 91. Accordingly, a hedge accounting must be discontinued and the hedging relationship de-designated if the hedge is no longer highly effective (ibid). The effectiveness test in figure 7.2 can be used to illustrate this. Assume that the forward contract were to depend on the forward exchange rate instead of the spot exchange rate. The change in value on the item and the instrument then depends on different indices, of which ineffectiveness may arise. The retrospective test shows that the actual result is a loss on the item amounting to USD 100 and a gain on the instrument of USD 130. The dollar offset method gives a result of 100/130, 76 per cent. The hedge is not highly effective.

The company will be forced to discontinue the hedge, and the accumulated change in fair value on the item must be amortized to profit and loss, according to IAS 39 p. 92 (IASB, 2012b).

The following paragraphs briefly explain the valuation of hedged items and hedging instruments. It continues explaining the accounting procedures for fair value and cash flow hedges to show how the offsetting effect is achieved. One main difference between the two relationships is that the changes in fair value on the instrument are treated differently (IASB, 2012b).

IAS 39 p.89 regulates the accounting procedure for fair value hedges (IASB, 2012b). The change in fair value on the hedging instrument is recognized as either an asset or a liability, with a corresponding gain or loss reported in profit and loss. The changes in fair value on the hedged item shall adjust its carrying amount and be accounted for in profit and loss. All changes in value are therefore accounted for in the income statement (ibid). This is visualized in figure 7.5. There is a gain of USD 1,000 on the asset (the item) and a loss of USD 1,000 on the forward contract (the instrument). The changes have occurred due to changes in foreign exchange rates.
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<table>
<thead>
<tr>
<th>Changes in fair value</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>USD 1,000</td>
<td></td>
</tr>
<tr>
<td>Profit and loss</td>
<td>USD 1,000</td>
<td>USD 1,000</td>
</tr>
<tr>
<td>Forward contract</td>
<td>USD 1,000</td>
<td></td>
</tr>
<tr>
<td>Profit and loss</td>
<td>USD 1,000</td>
<td></td>
</tr>
</tbody>
</table>

Total effect on profit and loss is +1,000 – 1,000 = 0. Notice how all changes end up in the income statement.

Figure 7.5 Changes in fair value

Shown in figure 7.7 is an example of a fair value hedge accounting. The company in figure 7.2 chooses to classify the hedge as a fair value hedge. Formal designation and documentation has been done and the company assesses the hedge to be highly effective. The company can now use hedge accounting to reduce the volatility in the income statement caused by the account receivable.

The hedged item in figure 7.2 is an account receivable to receive foreign currency. The value of the account receivable depends on the exchange rate at the day the company receives the cash. The fair value fluctuates with the spot rate, causing changes in fair value affecting profit and loss. The fair value on the forward contract is also dependent on the spot rate\(^1\). The spot rates in figure 7.6 are used when calculating the changes in fair value.

Figure 7.6 Changes in fair value

The initial change in fair value of the forward contract is accounted for as a loss in profit and loss and as a liability. The change between the balance sheet date and the date of maturity is accounted for as a gain in profit and loss and as an asset.

In figure 7.7, both the liability and the asset arising from the forward contract are accounted for in ‘Forward Contract’.

\(^1\) For the sake of simplicity, let us assume that the fair value of the forward contract is dependant only on the spot rate. Normally it would depend on the forward exchange rate.
Björn Forsberg, Linus Lindholm, Alexis Muhoza and Mikael Örtenvik

<table>
<thead>
<tr>
<th>Accounting entries – fair value hedge</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>09/01/X2</td>
<td>Accounts Receivable</td>
<td>USD 4,470,000</td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td>USD 4,470,000</td>
</tr>
<tr>
<td>The sale in EUR and the corresponding account receivable of EUR 3m is recorded in the functional currency USD according to the spot rate 1.49.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X2</td>
<td>Accounts Receivable</td>
<td>USD 30,000</td>
</tr>
<tr>
<td></td>
<td>Foreign Exchange Gain</td>
<td>USD 30,000</td>
</tr>
<tr>
<td>The value of the receivable is adjusted to fair value according to the new spot rate. As the spot rate appreciates from 1.49 to 1.50, a positive change in value is recorded.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Loss on Forward Contract</td>
<td>USD 30,000</td>
</tr>
<tr>
<td></td>
<td>Forward Contract</td>
<td>USD 30,000</td>
</tr>
<tr>
<td>The change in fair value of the forward contract is recorded as a liability and a loss. The fair value was zero at the inception of the hedge. When the spot rate changes, the market value of the hedging instrument changes with it.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>03/01/20X3</td>
<td>Foreign Exchange Loss</td>
<td>USD 60,000</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable</td>
<td>USD 60,000</td>
</tr>
<tr>
<td></td>
<td>Forward Contract</td>
<td>USD 60,000</td>
</tr>
<tr>
<td>Both the account receivable and the forward contract are adjusted to fair value according to the changes in the spot rate.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Gain on Forward Contract</td>
<td>USD 60,000</td>
</tr>
<tr>
<td></td>
<td>Foreign Currency</td>
<td>USD 4,440,000</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable</td>
<td>USD 4,440,000</td>
</tr>
<tr>
<td>Company A receives the EUR 3m cash from company B in the Netherlands. It is recorded at the current spot rate 1.48.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>USD 4,470,000</td>
</tr>
<tr>
<td></td>
<td>Foreign Currency</td>
<td>USD 4,440,000</td>
</tr>
<tr>
<td></td>
<td>Forward Contract</td>
<td>USD 30,000</td>
</tr>
<tr>
<td>Record of Company A paying EUR 3m in exchange for USD 4.470m and the removal of the forward contract. The high gain on the forward contract originates because we use the spot rates instead of the forward rates. The forward rates are lower than the spot rates.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Doupnik and Perera (2012)

Figure 7.7 Accounting entries – fair value hedge

As shown in figure 7.7, the hedging relationship and the use of hedge accounting offset the loss on the hedged item.

IASB (2012b) governs the accounting procedure for cash flow hedges in IAS 39 p. 95. The main feature is the distinction between effective and ineffective portions of the change in fair value. The definition of effective and ineffective is the same as in earlier paragraphs. The effective portion is according to p. 95 accounted for in other comprehensive income (OCI) while the ineffective portion is accounted for in profit and loss (IASB, 2012b).

The ineffective portion in the example used in figure 7.2 is the difference between the spot rate and the forward rate. The forward exchange rates were not used in figure 7.6
and 7.7, mainly because there is no need to when explaining a fair value hedge. They will be used in example 1.8 to help illustrate the ineffective portion of the hedge. The forward exchange rate is the rate at which a bank agrees to exchange one currency to another at a future date. Notice how the use of forward exchange rates in figure 7.9 creates an increase in cash flow of USD 6,000 instead of the USD 30,000 in figure 7.7. Using only spot rates creates a result too good to be true.

<table>
<thead>
<tr>
<th>USD/EUR forward rates</th>
<th>09/01/20X2</th>
<th>12/31/20X2</th>
<th>03/01/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.482</td>
<td>1.494</td>
<td>1.476</td>
</tr>
</tbody>
</table>

Figure 7.8 Forward exchange rates

Figure 7.9 shows the accounting entries for hedging a recognized asset. The information from figure 7.2 is used alongside the spot rates from figure 7.6 and the forward rates from figure 7.8.

When accounting for a cash flow hedge, IASB (2012b) wants the gain or loss on the effective portion of the instrument to be recognized in OCI in the same period as the profit or loss arising from the hedged asset. This moves any volatility from the income statement to the balance sheet. This is being visualized in figure 7.8, where crediting USD 30,000 in OCI with a corresponding debit in profit and loss offsets the gain of USD 30,000 on the accounts receivable. The ineffective portion must, as described above, be recognized in profit and loss. This is different from a fair value hedge where, according to IAS 39 p. 89, the ineffective portion is not treated any different compared to the effective.
**Accounting entries – cash flow hedge**

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>09/01/X2</td>
<td>Accounts Receivable</td>
<td>USD 4,470,000</td>
<td>USD 4,470,000</td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X2</td>
<td>Accounts Receivable</td>
<td>USD 30,000</td>
<td>USD 30,000</td>
</tr>
<tr>
<td></td>
<td>Foreign Exchange Gain</td>
<td>USD 30,000</td>
<td>USD 30,000</td>
</tr>
<tr>
<td></td>
<td>OCI</td>
<td>USD 36,000</td>
<td>USD 36,000</td>
</tr>
<tr>
<td></td>
<td>Forward Contract</td>
<td>USD 30,000</td>
<td>USD 30,000</td>
</tr>
<tr>
<td></td>
<td>Loss on Forward Contract</td>
<td>USD 30,000</td>
<td>USD 30,000</td>
</tr>
<tr>
<td></td>
<td>OCI</td>
<td>USD 30,000</td>
<td>USD 30,000</td>
</tr>
</tbody>
</table>

Instead of a loss being recorded in profit and loss, the corresponding entry to the liability occurs in OCI, presented in the Equity section of the balance sheet.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>03/01/20X3</td>
<td>Foreign Exchange Loss</td>
<td>USD 60,000</td>
<td>USD 60,000</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable</td>
<td>USD 52,000</td>
<td>USD 52,000</td>
</tr>
<tr>
<td></td>
<td>Forward Contract</td>
<td>USD 60,000</td>
<td>USD 60,000</td>
</tr>
<tr>
<td></td>
<td>OCI</td>
<td>USD 60,000</td>
<td>USD 60,000</td>
</tr>
<tr>
<td></td>
<td>Gain on Forward Contract</td>
<td>USD 12,000</td>
<td>USD 12,000</td>
</tr>
<tr>
<td></td>
<td>OCI</td>
<td>USD 12,000</td>
<td>USD 12,000</td>
</tr>
<tr>
<td></td>
<td>Foreign Currency</td>
<td>USD 4,440,000</td>
<td>USD 4,440,000</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable</td>
<td>USD 4,440,000</td>
<td>USD 4,440,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>USD 4,446,000</td>
<td>USD 4,446,000</td>
</tr>
</tbody>
</table>

*(1.49 – 1.482) * 3,000,000 = USD 24,000. USD 24,000 / 6 months = USD 4,000 per month.

This is the ineffective portion of the hedge, which is the difference between the spot rate and the exchange rate times the amount of the sale. This ineffectiveness is allocated to each month as an expense using straight-line allocation*. The first three months are accounted for at the balance sheet date.

Figure 7.9 Accounting entries – cash flow hedge

### 7.6 IFRS 9 – Third Phase

IFRS 9, *Financial Instruments*, was originally issued by the IASB in November 2009. It was the beginning of the project to replace IAS 39. Due to requests for a quick improvement, the IASB decided to divide the project into several phases. Several parts affecting classification and measurement of financial assets and liabilities are completed.
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Hedge accounting is the third and final phase. Unlike IAS 39, the IFRS 9 adopts a principles-based approach to hedge accounting. IASB’s exposure draft *Hedge Accounting* (2010) proposes several changes affecting what can be classified as hedged items and hedging instruments, effectiveness assessment and fair value hedges (IASB, 2010a).

IASB has also proposed an objective to hedge accounting, something that did not exist in IAS 39. The objective of hedge accounting would be (ibid):

…to represent in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risk that could affect profit and loss…

Hedge accounting is going to be more closely aligned with the company’s risk management, thus possibly resulting in more useful information for investors (ibid).

7.6.1 Hedging Instruments

According to IASB’s Exposure draft (ED) from 2010 there will be fewer restrictions than compared to IAS 39 when it comes to determine hedging instruments to be used in hedge relationships. This will result in more types of instruments that will be accepted as hedging instruments under IFRS 9. For example, Ernst & Young (2011a) mentions that any financial asset or liability measured at fair value through profit and loss (FVPL) will be approved for hedge accounting. Written options and internal derivatives will still be prohibited in the new standard. According to Ernst & Young (2011a) new rules for purchased option contracts with different recognizing methodologies for time value will be proposed. This, they argue, could diminish profit and loss volatility that often rises from option hedging. Furthermore, they point out that some restrictions from IAS 39 remain. As such, the entire hedging instrument has to be selected in hedging relationship.

7.6.2 Hedged Items

Under the ED there will be no further limitations regarding what qualifies as an item according to IAS 39. The intention is instead the opposite and some of the current restrictions should be removed. A bigger portion of a company’s risk management could be clarified through hedge accounting as a result of this. Ernst & Young (2011a) explains that the changed rules will permit derivatives to be included within the hedged item.

They also point out that the limitations in IAS 39 regarding risk components for non-financial items will also be removed. This means that financial and non-financial items can be described by the same rule. Kaiser (2011) shows how the components must be separately identifiable and reliably measurable. The eligibility of a risk component of a non-financial item is to be examined by reflecting following points (ibid):

- Assessments within the context of the particular market structure to which the risk relates and where the hedging activity takes place;
- Whether the risk component is explicitly specified in the contract (a contractually specified component); or
- Whether the risk component is implicit in the fair value or cash flows of the hedged item (Non-contractually specified risk component)
7.6.3 Hedge Accounting

Another difference is the accounting treatment for fair value hedges. IASB (2010a) believes both cash flow hedges and fair value hedges should be accounted for in the same place. Hence, changes in fair value of the hedged item and the hedging instrument will be shown in OCI. The ineffective portion will be moved to profit and loss (IASB, 2010a). Ineffectiveness will be covered in greater detail later in this paragraph.

Another change is the presentation of changes in the hedged item attributable to the hedged risk. Rather than adjusting the carrying amount of the hedged item, as under IAS 39, changes will be presented as a separate line item in the balance sheet (ibid).

IASB (2010a) proposes an objective to hedge effectiveness. The objective of the hedge effectiveness assessment in IFRS 9 would, according to the ED’s invitation to comment IN24 (a), be to “ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness” (IASB, 2010a). The first part of the objective means that companies are not allowed to construct hedging relationships with obvious mismatches in expected changes in fair value, which would deliberately produce hedge ineffectiveness. The second part is quite clear. Ernst & Young’s (2011a) opinion is however that it does not mean that companies must use the most effective hedging instrument no matter the costs.

IAS 39 AG105 has a bright line approach when it comes to hedge effectiveness assessment, requiring the result of the hedge to be within 80-125 per cent (IASB, 2010a). The ED’s IN24 shows no such bright line, in accordance with the aforementioned objective (ibid). The only requirement in paragraphs B27-39, which govern the proposed hedge effectiveness criteria, is that the result must be around 100 % (ibid). Fairly much variation is allowed as long as the overall result is close to 100 %. In other words, there is no requirement to pass a retrospective test in order to continue using hedge accounting (ibid).

The Exposure Draft does not require a particular method when assessing the hedge effectiveness (ibid). Rather, companies should use one that “captures the relevant characteristics of the hedging relationship including the sources of ineffectiveness” (ibid). Ernst & Young (2011a) has voiced concern that changes in the hedging relationship may result in new sources of ineffectiveness. In this case, IASB requires companies to change the method into one that includes all sources.

Ernst & Young (2011a) believes that one of the most important efforts to align the hedge accounting in IFRS 9 with the company’s risk management is the qualitative effectiveness assessment option in the ED. IASB (2010a) proposes in B34 that if the relationship between the hedged item and the hedging instrument is “closely aligned” then the company can use a qualitative method. Notice how this is different from the test in figure 7.3, where the critical terms had to match each other perfectly in order for a qualitative test to be used. Looking at the objective of hedge accounting, companies are also allowed to use the same methods used in their risk management projects, if appropriate (ibid).

The ED proposes a different approach than IAS 39 for when the hedge is no longer assessed to be highly effective, which is closely aligned with the new objective of the hedge effectiveness assessment (ibid). Looking back at the example used in 7.5.6, the company was forced to de-designate the hedge when it was no longer effective and designate a new relationship if they wished to continue hedge accounting. Item 23 in the ED states that the company shall try to rebalance the hedge instead of discontinue and re-
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designate it (ibid). If the rebalancing fails, then item 24 states that it must discontinue the hedge.

Measurement of hedge ineffectiveness will not differ from the methods used in IAS 39 (ibid). For a cash flow hedge, ineffectiveness will be recognized when the changes in fair value of the hedged item are lower than the changes on the hedging instrument. This will result in the same ineffectiveness being recognized as in figure 7.9. The accounting for fair value hedges is changed in item 26 (IASB, 2010a). It states that any difference between the change in fair value of the item and the instrument will be recognized as ineffectiveness and moved to profit and loss.
7.7 Summary

IAS 39 is largely rule-based and includes many limitations on what can be used as hedged items and hedging instruments. Hedge accounting is only allowed if the hedge passes both a hypothetical prospective test and a retrospective bright line test. If the hedge fails to pass the tests, the company must discontinue hedge accounting. The hedges are divided into separate hedging relationships, of which fair value hedges and cash flow hedges are the most common. Fair value hedges affect profit and loss immediately, while cash flow hedges go through equity first.

The proposed IFRS 9 will be more principles-based and many of the limitations in IAS 39 are relaxed. The standard removes the retrospective bright line test, allowing hedge accounting as long as the result is close to 100 per cent. The prospective test will still be required. A qualitative test will allow companies to use the same tests as in their risk management strategy. If the test fails, companies will use rebalancing in order to achieve effectiveness instead of having to discontinue. Fair value hedges and cash flow hedges are both going to go through equity before affecting profit and loss. Shown in figure 7.10 is a summary of the major features in standards.

<table>
<thead>
<tr>
<th>Subject of change</th>
<th>IAS 39</th>
<th>IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged item</td>
<td>Derivatives cannot qualify for hedged items. Only risk components of financial items are allowed to qualify for hedged items. Non-financial items can only be hedged in their entirety.</td>
<td>Derivatives will be included within the hedged items. In addition to what is required in IAS 39, even risk components of non-financial items will qualify for hedged items.</td>
</tr>
<tr>
<td>Hedging instrument</td>
<td>Other assets or liabilities than derivatives are eligible only if the risk is a foreign currency exchange risk</td>
<td>Any financial asset or liability valued through profit and loss will be eligible.</td>
</tr>
<tr>
<td>Effectiveness</td>
<td>Prospective and retrospective effectiveness tests required. Actual result must be within 80-125 per cent. Hedge is discontinued if it fails any of the tests.</td>
<td>No retrospective test. Qualitative test allowed. Rebalancing rather than discontinuation.</td>
</tr>
<tr>
<td>Ineffectiveness</td>
<td>Ineffectiveness is only recognized when the change in fair value on the instrument is greater than the change in value on the item.</td>
<td>Ineffectiveness on fair value hedges is recognized as any difference between the changes in fair value.</td>
</tr>
<tr>
<td>Fair value hedges</td>
<td>Changes in fair value are recognized in profit and loss.</td>
<td>Changes are recognized in other comprehensive in-come.</td>
</tr>
</tbody>
</table>

Figure 7.10 Summary of major changes
7.8 Analysis and Discussion

This section contains a discussion centered on the questions posed in the introduction, where different views on the standards will be presented in order to help answer said questions. The examined comment letters have been chosen to represent national standard setters, financial institutions and preparers of financial statements. Focus lies on the national standard setters and the preparers, to comply with the purpose of the chapter.

7.8.1 What is the Perception of the new Standard among Standard Setters and Preparers of Financial Statements?

The objective of IFRS 9 is as stated in section 1.6 to represent the effects of the entity’s risk management activities. The ED uses the objective as basis for the new hedge effectiveness assessment and consequently it serves as the basis when companies have to decide whether to continue or discontinue a hedge.

The European Central Bank (ECB, 2011) believes that a more precise definition of the objective is needed to avoid unintended consequences. Ernst & Young (2011b) has in their comment letter to the ED expressed their concerns about the lack of a clear definition. Other organizations do not seem to share this concern. FAR (2011) does not mention any lack of definition in their comment letter; nor does the Accounting Standards Board (ASB, 2011) in theirs.

The ED has also proposed an objective to the hedge effectiveness assessment. FAR (2011) believes this objective may cause designations for hedge accounting purposes to be different than designation for risk management activities. This is because the objective does not allow a hedge to be biased and states that the hedge must minimize hedge ineffectiveness. For instance, a company may want to use a hedge ratio of 1:1 in their risk management, an asset worth USD 1000 is hedged with an instrument worth USD 1000. It is easy to understand and monitor. It may however give rise to ineffectiveness. Subsequently, the company will not be allowed to use the same ratio in hedge accounting as they do in their risk management (ibid). Ernst & Young (2011b) expresses the same concern as FAR. They think that the objective of the assessment restricts the level of judgment companies are allowed to apply to their accounting, which in other words restricts the companies’ ability to their risk management activities.

IASB (2010c) has mentioned reduced complexity as a reason for the changed reporting practices of fair value hedges. There are however, organizations that completely disagree with the proposed items in the ED. Ernst & Young (2011b) has expressed a concern in their comment letter that the new treatment of fair value hedges instead adds complexity for companies. The ASB (2011) thinks that the two-step approach, described in section 1.6.3, is unnecessary. The added benefits for the users, they argue, are limited and the increased complexity is therefore not justified. FAR (2011) expresses similar concerns. The mentioned organizations prefer the current treatment of fair value hedges, shown in the example in figure 7.7. Others have expressed a more positive response but still raise some questions. Institut der Wirtschaftsprüfer (IWD, 2011) thinks that the board needs to clarify unresolved issues regarding OCI. One example of this is when changes in fair value are supposed to be recycled to profit and loss.

Another matter discussed is if the hedged item attributable to the hedged risk must be presented as a separate line item in the statement of financial position. Several of the
organizations that have answered with comment letters are concerned with the amount of information that could be presented in the primary financial statements. Ernst & Young (2011b) argues that the statements could become cluttered and proposes that the information is presented in a separate note instead. FAR (2011) expresses a similar opinion and IWD (2011) writes that, in some cases, “...the resulting level of disaggregation in the primary financial statements would be inappropriate...”

At first IASB (2010c) considered treating fair value hedges and cash flow hedges with one and the same rule. They mention that the feedback received regarding this original notion made them reconsider this (ibid). One of the concerns expressed was that it would make movements in OCI less understandable. Because of the objections expressed in the feedback they settled on a treatment similar to cash flow hedges.

The proposed change in the effectiveness criteria, from the bright line 80-125 per cent method described in section 1.5.6 to the more lenient method described in section 1.6.4, introduces a more subjective view on the tests according to ASB (2011). FAR (2011) has stated that this change may give companies an incentive to use hedge accounting. ASB (2011) agrees, saying that the removal of the bright line method will open up hedge accounting to a wider range of companies.

In the comment letter from the European Association of Co-Operative Banks (EACB, 2011), the inclusion of non-derivative financial items valued at FVPL within eligible financial instruments is highly welcomed. Furthermore it is pointed out that the determining factor for what qualifies as hedging instruments should be the actual possibility to reduce risk instead of the classification of the instrument. Responders such as Business Europe (2011) and ASB (2011) also believe that the proposed change in hedging instruments will make it possible for hedge accounting to reflect how risks are hedged in practice.

According to the ED, IFRS 9 will also, as mentioned before, allow the aggregate exposure that is a combination of another exposure and a derivative to qualify for hedged items (IASB, 2010a). This is something that many of the organizations agree with in their comment letters. Some of the responders including Association of Chartered Certified Accountants (ACCA, 2011) and ASB (2011) believe that this approach will be more closely aligned with a company’s risk management strategy. Deloitte (2011) thinks the change would be consistent with the objective presented in IFRS 9.

7.8.2 In What Manner Does IFRS 9 Better Reflect Risk Management Activities of Companies?

We consider the introduction of an objective to hedge accounting to be an important factor in order to lower the complexity and to align the accounting with the companies’ risk management activities. Our opinion is that the removal of the retrospective effectiveness test and the introduction of an objective to hedge effectiveness measurement is a good way to ensure that preparers can use the same hedges in their financial statements as they use within their risk management activities. We saw earlier how FAR and Ernst & Young expressed concern that the wording of the objective would restrict companies’ ability to the same hedges as in their risk management. We have no doubt though that this issue will be sorted out before the final release of the standard.

We do not think that the changes regarding fair value hedges reduce the complexity in applying the standard. We feel that the IASB should have either kept fair value hedges as it was, or treat both fair value and cash flow hedges in the same manner. As it is proposed
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now, the rules for fair value hedges are similar but not the same as the ones for cash flow hedges. We believe that this will, at least in the early adoption of the standard, add confusion to companies when they try to understand the differences between the two hedges. We think that the standard will be more accessible to the preparers if the IASB uses their original notion to treat the hedges the same way.

In order to let IFRS 9 better reflect the risk management activities of entities, we believe the IASB must ensure that the objective of hedge accounting is widely recognized. While examining the comment letters, we found how the interpretation of the objective differed among the respondents. Ernst & Young believed that companies should be allowed to depart from the standard if the alternative accounting procedure better reflects the entity’s risk management, while the ASB completely disagreed with the proposed objective. Instead they believe hedge accounting to be a way for companies to reflect their hedging strategy in their financial statements, not as a way to show the risk management. The IASB introduced an objective to hedge accounting in order to better align it with companies’ risk management activities. We believe that they will fail if they do not make sure the objective is recognized among the preparers of the financial statements. Otherwise it does not matter whether the specific rules are less complex or not.

7.9 Conclusion

Hedge accounting has been a widely criticized field ever since the first adoption of IAS 39 and researchers have called it the make-or-break case of the IASB (Bryer, 2004). Many sections of the standard have been complex and restrictive, as visualized in this chapter. Many of the examined responders welcomed the initiative to introduce an objective to hedge accounting, though many would like to see a more clear definition of the objective. We believe an objective is a good move. It should allow companies to better use their risk management strategies in their hedge accounting. It might also allow further relaxation of the limitations currently existing in the ED, though it is important that the objective is clear. Otherwise it might actually lead to preparers feeling like there are more limitations than before. The objective is integrated in the hedge effectiveness assessment. We question the use of the hedge objective in the effectiveness assessment as it is currently used in the ED. We agree with many of the responders, who believe that the objective will limit companies’ ability to use the same hedge ratios in their hedge accounting as they do in the risk management strategy. We do believe that a clearer definition of the hedge effectiveness objective together with the option to use qualitative tests will bring the accounting and the strategy closer to each other. Furthermore, the removal of the retrospective test should open up hedge accounting to a wider range of companies.

One area where, in our opinion, the proposed changes increase complexity rather than making accounting easier for companies is fair value hedges. We think this is a result of an unconsidered attempt to treat cash flow hedges and fair value hedges with the same rule. Instead of making hedge accounting less complex it rather adds complexity to it. From the responses in the comment letters it is clear, that several organizations agree with our conclusion that the proposal makes accounting for fair value hedges more complicated. Companies’ risk management activities often include the use of non-financial items and instruments. The use of these items and instruments was subject to
Björn Forsberg, Linus Lindholm, Alexis Muhoza and Mikael Örtenvik

limitations under IAS 39. This is a big step in order for companies to show all of their hedging activities to the users.

The change from IAS 39 to IFRS 9 brings a lot of improvements to hedge accounting. We have identified many welcomed changes but there are still some areas where more consideration is needed. Still, it is too early to know what the final outcome will look like. IAS 39 was revised many times over the years and IFRS 9 will probably face the same fate. We believe that the move to a principles-based standard has done much in order to better reflect companies’ risk management activities, but there is still a need to further investigate how to simplify hedge accounting.

7.10 Questions

• Explain the two major differences between accounting for fair value and cash flow hedges according to IAS 39.

• Describe the required hedge effectiveness assessments both according to IAS 39 and IFRS 9.

• Identify one major area in hedge accounting where the standard setters and the preparers disagree with the IASB’s proposed exposure draft.
Hedge Accounting - Simplified with new rules?

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Internet:


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8.1 Introduction

A key topic in accounting is revenue and it plays an important role for the users of financial information in their decision-making. Revenue is a crucial number in assessing an entity’s performance and prospects when comparing entities (IASB 2010). Revenue is surrounded by several difficulties regarding when to recognize revenue and to what amount. What makes the subject revenue even more difficult is the lack of uniform requirements. In countries following International Financial Reporting Standards (IFRS) there are two standards covering revenues, IAS 18 Revenue and IAS 11 Construction Contracts (IASB 2010). However, the two standards do not provide sufficient guidance to cover the range and complexity of revenue transactions (Carmichael et al. 2007). In the US there are numerous industry- and transaction-specific requirements that can result in different accounting for economically similar transactions (IASB 2010). There are more than 200 different authoritative pronouncements, which make a comparison between the IFRS and the US Generally Accepted Accounting Principles (GAAP) difficult (Doupnik and Perera 2012).

The thought of having a common standard worldwide was introduced in the beginning of the 1980s with the establishment of the International Accounting Standards Committee (IASC). Thereafter, the standards issued have been subject to amendments several times as a result of the globalization. The pressure of having a common set of standards worldwide has increased due to increasing international trade and foreign direct investments (FDI). As a result, stakeholders have developed a greater need to understand and compare foreign financial reports.

The international standard setter, the International Accounting Standards Board (IASB), is currently working together with the US standard setter, the Financial Accounting Standards Board (FASB), with the mutual goal to harmonize and converge their standards and find a common solution to existing problems (Doupnik and Perera 2012). One of their projects aims at removing inconsistencies and weaknesses in existing standards regarding revenue recognition. The project is to develop a single standard, Revenue from Contracts with Costumers, which will facilitate revenue recognition
among a wide range of transactions and industries (Ibid.). The standard applies to all contracts with customers except leases, financial instruments and insurance contracts (IFRS 2011, 9).

This chapter seeks to describe the reasons behind the convergence project of revenue recognition between the FASB and the IASB. Additionally, the question regarding how the new standard, Revenue from Contracts with Customers, will affect entities and users of financial statements will be discussed.

After reading this chapter the reader should be able to:

- Describe the development of revenue recognition.
- Understand the problems related to the current standards regarding revenue recognition.
- Understand the structure and purpose of the new standard, Revenue from Contracts with Customers.

8.1.1 Disposition

The disposition of this chapter is to describe the past, the present and the future of revenue recognition, including an overview of the main standards discussed in this chapter, IAS 18 Revenue and IAS 11 Construction Contracts. The development of revenue recognition is described and also the current difficulties regarding this subject; when to recognize revenue and to what amount. This is followed by the structure and purpose of the new standard. Finally, an analysis and discussion will be made in order to answer the questions of this chapter.

8.2 Standards regarding revenue recognition and the due process

8.2.1 IAS 18 Revenue

In IAS 18, revenue is income that arises in the course of ordinary activities of an entity and is generated from sales, fees, interest, dividends and royalties. The objective of IAS 18 is to prescribe the accounting treatment of revenue arising from certain types of transactions and events. Revenue is recognized when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably (IAS 18). The main criterion for revenue recognition is that the significant risks and rewards of ownership of the goods have been transferred to the buyer (Doupnik and Perera 2012).

8.2.2 IAS 11 Construction Contracts

The objective of IAS 11 is the treatment of revenue and costs associated with construction contracts. IAS 11 defines construction contracts as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use (IAS 11.3). There are two types of contracts, fixed price contract
or cost plus contract. Construction contracts are special because of their nature, where the activities under the contracts often are performed under different accounting periods. When the outcome of a construction contract can be estimated reliably, construction contracts shall be recognized as revenue and expenses by reference to the stage of completion. This method is referred to as the percentage of completion method (IAS 11).

8.2.3 Development of the IFRSs

IFRSs are developed through an international consultation process, the due process, which involves interested individuals and organizations worldwide (IFRS 2012). This process includes six stages, starting with setting the agenda, meaning that the IASB evaluates potential items to add to their agenda. The second step is planning the project, which includes deciding whether to conduct the project alone or jointly with another standard setter. Developing and publishing the discussion paper is the third step in the process. A discussion paper should contain a comprehensive overview of the issue, possible approaches in addressing the issue, the preliminary views of its authors or the IASB and an invitation to comment. Developing and publishing the exposure draft is the fourth step when changing a standard. An exposure draft is the IASB’s main instrument for consulting the public. An exposure draft sets out a specific proposal in the form of a proposed standard (or amendment to an existing standard). The fifth step is developing and publishing the standard and the sixth step is issuance of the standard (Ibid.).

8.3 The past – the development of revenue recognition

With the rise of many multinational companies in the 1960s the need to compare financial statements from different parts of the world increased (Camfferman and Zeff 2007). Therefore, the IASC was founded in 1973 to harmonize different accounting practices across countries and to narrow the differences across national accounting standards. The IASC’s objective was the development of a single set of global accounting standards accepted by organizations around the world (Ibid.). In 1981, the process of issuing IAS 18 and the framing of revenue recognition began by the publication of the Exposure Draft E20 (Deloitte 2012a). The exposure draft defined revenue and outlined the criteria for revenue recognition.

The first version of IAS 18 was issued in December 1982 and the effective date was January 1984 (Deloitte 2012a). As the pace of the globalization increased in the 1980s and especially in the 1990s, the IASC began improving its standards to meet a higher level of quality that commanded the attention and respect of national and regional regulators, standard setters, leading accountancy bodies and multinational companies worldwide (Camfferman and Zeff 2007). The IASs developed in the 1980s tended to be very broad, allowing many alternative accounting treatments (Zeff 1998). With the objective of the IASC to increase comparability between countries this was a serious weakness. To gain acceptability of its standards, the IASC undertook the “Comparability Project” in 1989, aimed at enhancing comparability of financial statements by reducing alternative treatments. Ten standards were included in the project to be revised and one of them was IAS 18 (Zeff 1998). Another exposure draft on revenue recognition was published in May 1992, named E41 (Deloitte 2012a). The exposure draft provided a more clear and operational definition of revenue and guidance of revenue recognition. The
Effective date of the revised IAS 18 was January 1, 1995 (Deloitte 2012a). Revenue in the reviewed edition was defined as:

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants (IAS 18.7).

In 2001, the IASB took over from the IASC as the creator of international accounting standards, which were to be called IFRS (Doupnik and Perera 2012). The IASB adopted IAS 18 and the definition above still applies today.

8.4 The Present – issues regarding recognition and measurement of revenue

Revenue is an important area in accounting and of important value for users of financial statements when assessing an entity’s performance and position. The main cause of weakness in financial reporting is failure in internal controls over revenue recognition and the accounting of revenue recognition has been, and continues to be, one of the top accounting and auditing areas of risk (PwC 2012). The IFRS and the US GAAP have different accounting methods for revenue recognition and both sets of requirements need improvement (Deloitte 2012b).

The main issues within the IFRS and the US GAAP are their broad revenue recognition criteria and their disclosure requirements that often result in information that is inadequate for users, when trying to understand an entity’s revenues (IASB 2010). In US GAAP, revenue recognition comprises more than hundred standards and numerous requirements for particular industries that can result in different accounting for economically similar transactions. Although IFRS have fewer requirements on revenue recognition, the two main standards under IFRS, IAS 18 and IAS 11, are inconsistent and vague (FASB 2008). In particular, the standards provide limited guidance for transactions involving multiple components and are therefore difficult to apply to complex transactions, which can result in diversity in practice (IASB 2010).

IAS 18.13 addresses the identification of the transaction, i.e. how to account for the delivery of more than one good or service, that is, a multiple element arrangement. The paragraph states that transactions sometimes should be divided into components:

[…] in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

Although, it does not clearly state when or how an entity should separate a single transaction into components (FASB 2008). The guidance in IAS 18.13 is insufficient, resulting in entities applying different measurement approaches to similar transactions. As a consequence of the lack of guidance, the comparability of revenues across entities will be reduced (FASB 2008).
Revenue Recognition – the past, the present and the future

The main source when recognizing revenue is the contract with the customer. The contract describes elements that may influence when to recognize revenue, i.e. if there are one or more separable revenues and when the risk will transfer to the buyer (CFO World 2011). According to IAS 18.14, revenue from the sale of good shall be recognized when all the following conditions have been satisfied:

• the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
• the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
• the amount of revenue can be measured reliably;
• it is probable that the economic benefits associated with the transaction will flow to the entity; and
• the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Many contracts include the delivery of both a good and a service and it is common that a good includes the installation and/or a service contract. Problematic is to determine how many components should be recognized as revenue; is the installation a separate service or is the delivery of the good not accepted until the installation is done (CFO World 2011)? Entities often consider the transaction as a whole to determine when the risks and rewards of ownership are transferred (FASB 2008). This may result in an entity recognizing all of the revenue when delivering the good, although contractual obligations for the services related to the good still remains, i.e. a warranty (Ibid.). As a result, revenue does not represent the pattern of the transfer to the customer of all of the goods and services in the contract. Moreover, an entity might recognize all of the profit in the contract before the entity has fulfilled all of its obligations (FASB 2008, p.3).

In many countries, entities offer the customers the right to return a good within a limited time period and the seller has to repurchase the good. This regulation is a separate clause in the contract and the entity must therefore evaluate if there has been a sale (CFO World 2011). A sale has only occurred if the significant risks and rewards of ownership have been transferred to the customer. If these elements still belong to the seller, you may argue that the sold good only has been borrowed to the customer. Thus, no transaction generating revenue has been made and no sale will be accounted for. This is a recurring problem that many stores face. A common solution is to calculate the amount of goods being returned, based on historical data, and decrease the sales by this amount (Ibid.).

As mentioned, revenue recognition for the sale of a good depends largely on when the risks and rewards of ownership of the good are transferred to a customer. This may result in an entity recognizing amounts in the financial statements that do not faithfully represent economic phenomena (FASB 2008).

IAS 18 is a broad standard, whereas IAS 11 only contains details for the accounting of a narrow kind of transaction; construction contracts (Ciesielski and Weirich 2011). The primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed (IAS 11). To apply the percentage of completion method the outcome of a
construction contract has to be estimated reliably according to the standard. This result in practical difficulties since the criterion “estimated reliably” is unclear and requires subjective assessments.

A further problem in IAS 18 and IAS 11 is distinguishing between goods and services, which may result in some entities defining a contract as a construction contract, whilst other entities defines a similar contract as a contract for goods (FASB 2008). This results in entities recognizing revenue differently, since the revenue from a construction contract is recognized throughout the construction process, whereas a contract for goods recognizes the revenue when the risks and rewards of the transaction are transferred to the customer. The lack of a clear distinction between goods and services reduce the comparability of revenue across entities (Ibid.). The two standards have two separate ways of recognizing revenue and lack of a clear revenue recognition principle and the standards are therefore perceived as inconsistent (Henry and Holzmann 2009).

As a result of the mentioned issues, the IASB and the FASB (the boards) founded the Norwalk Agreement in September 2002 (Mintz 2009). Their mission was to make their existing financial reporting standards fully compatible and to coordinate their work program to ensure that once achieved, compatibility is maintained. The Norwalk Agreement was an initiative to further convergence between the IFRS and the US GAAP and among other things a commitment to work together on joint projects (Doupinik and Perera 2012, p. 101). One of the major joint projects is Revenue from Contracts with Customers with the intent to converge the rules regarding revenue recognition of the FASB and the IASB and, if necessary, also revise the Framework of the IASB (Carmichael et al. 2007).

8.5 The Future –Revenue from Contracts with Customers

In June 2010, an exposure draft on revenue recognition titled Revenue from Contracts with Customers was issued. The initial proposal generated nearly 1,000 comment letters and in November 2011 a revised exposure draft was issued (Lamoreaux 2012). Comments on the revised exposure draft were to be received by March 13, 2012 and a final revenue standard is expected to be in use from January 1, 2015 (Ibid.). The stated objectives of the exposure draft as reported by the boards are to:

- remove inconsistencies and weaknesses in existing revenue requirements;
- provide a more robust framework;
- improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets;
- provide more useful information to users of financial statements through improved disclosure requirements; and
- simplify the preparation of financial statements by reducing the number of requirements to which entities must refer (IFRS 2011, IN2).

The exposure draft presents a revenue recognition model using an asset and liability approach (Olsen and Weirich 2010). The main objective with this approach is to identify and measure the impact a contract has on assets and liabilities. When an
entity has satisfied a performance obligation that results in an increase in the contract asset or a decrease in the contract liability, revenue is recognized (Olsen and Weirich 2010, p. 55).

8.5.1 The five step model

The boards describe the core principle when recognizing revenue in the draft standard as follows:

[...] an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services (IFRS 2011, IN9).

The proposed standard will be applied to all contracts that provide goods or services to customers. Leases, insurance contracts and financial instruments are types of contracts that are excluded (IFRS 2011, 9). To apply the standard and achieve the core principle, an entity must use the following five step model:

Step 1: Identify the contract(s) with the customer

Step 2: Identify the separate performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocate the transaction price

Step 5: Recognize revenue when a performance obligation is satisfied

Figure 8.1. Steps in Applying Revenue Model. (Olsen and Weirich 2010, p. 56)

Step 1 is to identify the contract with the customer. According to the exposure draft, a contract exists when “an agreement between two or more parties creates enforceable rights and obligations between those parties”. This contract can be written, oral or implied by an entity’s customary business practices (Lamoreaux 2012, p. 32). Entities usually account separately for the revenues of a single contract. However, there are circumstances requiring that a contract either can be combined with other contracts or segmented into two or more contracts (Olsen and Weirich 2010, p. 56). If the price of some of the goods or services is independent from the price of other goods or services contained in a single contract, the contract would be segmented. The exposure draft specifically states that to segment a contract the goods or services must regularly be sold
separately and the customer must not receive a significant discount (Olsen and Weirich 2010, p. 57).

As step 2, the entity is obliged to identify the separate performance obligations in the contract (Lamoreaux 2012). A separate performance obligation is a promise to transfer a distinct good or service to a customer. The exposure draft states that a good or service is distinct if either of the following conditions is met:

- The entity regularly sells the good or service separately.
- The customer can benefit from the good or service on its own or combined with other resources that are readily available to the customer (IFRS 2011, IN13).

The third step is to determine the transaction price, which is defined as the amount of consideration that an entity expects to be entitled to receive in exchange for transferring goods or services (IFRS 2011, IN16). When determining the transaction price an entity also has to contemplate the variable consideration, the time value of money, non-cash consideration and consideration payable to the customer. If the consideration in a contract is variable, an entity should measure the transaction price using either a probability-weighted method or the most likely amount. The promised amount of consideration has to be adjusted to reflect the time value of money if the contract has a financing component that is significant to the contract. Non-cash consideration is to be measured at fair value. The last thing to contemplate when determining the transaction price is consideration payable to the customer. If an entity pays, or expects to pay, consideration to a customer in the form of cash, credit or other items that the customer can apply against amounts owed by the entity, the entity would account for the consideration payable to the customer as a reduction of the transaction price unless the payment is in exchange for a distinct good or service (IFRS 2011, IN16).

Step four is to allocate the transaction price to the separate performance obligations for contracts that has more than one separate performance obligation (IFRS 2011, IN18). The entity should allocate the transaction price in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation (Ibid.).

The last step is for the entity to recognize revenue when a performance obligation is satisfied, i.e. when a promised good or service is transferred. A good or service is transferred when the customer obtains control of that good or service (IFRS 2011, IN22). Some indicators that the customer has obtained control are an unconditional obligation to pay, legal title to the asset or physical possession of the asset (Olsen and Weirich 2010, p. 59).

8.5.2 Comments on the revised exposure draft on revenue recognition

The comment period on the revised exposure draft ended on March 13, 2012. The boards received approximately 350 comment letters on the proposal, significantly fewer than the nearly 1,000 they received on the initial exposure draft issued in June 2010 (Crowley et al. 2012). The feedback from most industries was similar and generally indicated support for the boards’ efforts to develop a single comprehensive revenue recognition standard (Crowley et al. 2012). Although, some areas of concern were raised.
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One area where the respondents requested further clarity was the issue of identifying separate performance obligations. The second step in the five step model states that a bundle of distinct goods or services would be combined into a single performance obligation when certain criteria are met (Crowley et al. 2012). KPMG writes in their comment letter to the boards the following example to illustrate the issues: if a vendor regularly sells a unit of service separately, it is clear that the unit of service is distinct. However, if the vendor does not sell the unit of service separately, it is less clear how the vendor would evaluate whether a customer can benefit from the unit on its own or together with other resources that are readily available to the customer. The respondents asked for further clarity to which units of service in the contract would be considered distinct and, thus, separate performance obligations (KPMG IFRG Limited 2012).

When determining the transaction price, in order to recognize revenue, an entity has to consider the time value of money. Many commented that the proposed requirements for adjusting the time value of money could be extremely complex and difficult to apply, especially within longer-term contracts with multiple elements and variable consideration (Crowley et al. 2012). Respondents suggested that the boards either eliminate the requirements or provide more detailed examples of how to apply this guidance (Ibid.).

The boards requested comments on the entire revised exposure draft but specifically sought feedback on six aspects, one of them was the proposed interim financial statement disclosure requirements (Crowley et al. 2012). Most respondents believed that the proposed disclosures would be overly burdensome and costly to prepare (Ibid.).

The respondents have given their views on the revised exposure draft and it is now up to the IASB and the FASB to process the comments, and hopefully the boards and the users will be satisfied with Revenue from Contracts with Customers.

8.6 Summary

Revenue is a key factor in accounting and of important value for users of financial statements when assessing an entity’s performance and position, therefore it is important that revenue is recognized and measured properly. Under IFRS there are two standards covering revenue recognition, IAS 18 and IAS 11. The issues with these standards are that IAS 18 is a broad and vague standard and that IAS 11 only applies to the accounting of a narrow kind of transaction. Under US GAAP the issues are that revenue recognition comprises more than hundred standards and numerous requirements for particular industries that can result in different accounting for economically similar transactions.

To address these issues, the IASB and the FASB decided to work together to make their existing standards fully compatible. One of their joint projects aims at converging the rules regarding revenue recognition in the new standard, Revenue from Contracts with Customers. The stated objectives of the standard are to remove inconsistencies and weaknesses in existing revenue requirements, improve comparability and provide more useful information to the users of financial statements. The standard is expected to be in use from January 1, 2015.
8.7 Analysis and discussion

To illustrate how the new standard, Revenue from Contracts with Customers, will affect entities an example will be given. First, assumptions will be made of how the example will be accounted for under IAS 18 and then how the transaction will be accounted for under the exposure draft of the new standard. The example is how to account for multiple element arrangements, a transaction that causes problems for entities.

<table>
<thead>
<tr>
<th>Example</th>
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<tr>
<td>Sale of a copy machine that includes service under a specific period of time to the total price X. The entity also sells copy machines and services separately, but at a higher total price, Y, than if sold combined.</td>
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It is problematic to determine whether the copy machine and the service are to be seen as one component, where the revenue will be recognized at the same time, or if the machine and the service should be divided into two separate components with different times for the revenue recognition.

8.7.1 IAS 18 Revenue

As previously mentioned IAS 18.13 addresses when transactions can be divided into one or more components. The paragraph states that when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. The decisive factor is whether there is an identifiable amount for the different components. In this example, the difficulties are to determine what proportion of the contract price X that applies to the value of the copy machine and what proportion that applies to the value of the service.

The prices of multiple element arrangements are probably decided from customer to customer since the prices are negotiated and possibly discounted for long term customers. It can be problematic to tell which component the discount applies to and hereby it is difficult to determine the definite price for the copy machine and the definite price for the service. In addition, it is problematic to estimate the value of the service since it is hard to forecast the amount of service that will be performed. Based on these issues it is difficult to recognize the identifiable amount and therefore the copy machine and the service should be considered as one component.

The next step is to identify when to recognize revenue according to IAS 18.14. The significant risk and rewards of ownership has to be transferred to the customer and this criterion is fulfilled when the copy machine is delivered to the customer, and at the same time the revenue is recognized. As a result, the revenue from the sale of the copy machine and service is recognized, although the entity still has obligations regarding the service towards the customer. In fact, the service should be considered as a rendering of service and thereby the revenue should be recognized on a straight-line basis over the specified period (IAS 18.25). However, the two components cannot be separated and are therefore considered as one component. Hereby, the revenues are recognized at the same time.
8.7.2 Revenue from Contracts with Customers

To recognize revenue an entity has to follow the five-step model according to the standard. The first step is to identify the contract with the customer. The sale of the copy machine and the service is a contract that creates enforceable rights and obligations between the seller and the customer. However, there are circumstances requiring that the contract is segmented into two contracts. To decide whether to segment the contract or not one must find out if the price of the copy machine is independent from the price of the service. The copy machine is sold combined with service to the total price of X. This price, X, is lower than if the copy machine and the service were sold separately, the total price Y. The customer would probably not include the service in the contract if it was not a more favorable price. Because price Y is higher than price X the price of the copy machine and the service is not independent and therefore, the contract should not be segmented.

The second step is to identify the separate performance obligations in the contract, which is the promise to transfer a distinct good or service to a customer. The copy machine and the service is distinct if the entity either regularly sells them separately or if the customer can benefit from them on their own or combined with other resources. Because the entity regularly sells copy machines and services separately, the copy machine and the service in the example can be seen as distinct. Thereby, the contract consists of two separate performance obligations.

The third step is to determine the transaction price. In the example the price is X, which is the amount that the entity expects to receive from the customer and thus X is the transaction price.

Step four is to allocate the transaction price to the two separate performance obligations. The copy machine and the service each have a stand-alone selling price and these prices are put in proportion to the transaction price X to determine the allocation of the transaction price.

The last step is for the entity to recognize revenue when a performance obligation is satisfied. The revenue recognition of the copy machine is done when the copy machine is delivered and the customer obtains control of that good. The service included in the contract runs for a specific period of time and the revenue will be recognized when the service is performed. To summarize, revenue will be recognized when the service is performed, at least one time depending on the contract, and when the copy machine is delivered.

8.7.3 The effect on entities

Depending on which standard applied the accounting for the example turned out different. When applying IAS 18 the sale was seen as one component and the revenue was recognized once. Under Revenue from Contracts with Customers the sale was seen as two separate performance obligations and the revenue was recognized at different times. Although, consideration must be given to the assumptions made by the authors, other assumptions could have led to different results.

The accounting under the exposure draft resulted in revenue being recognized at different times for the copy machine and the service because of the guidance in the new standard. In comparison to existing revenue standards, the new standard provides more and clearer guidance how to account for multiple element arrangements and this
facilitates the accounting for these transactions. The gathering of the rules of revenue recognition in one standard ought to facilitate for entities and the five step model will be used for all revenues. This will make it easier, since revenue will be recognized in the same way regardless of whether it comes from a sale of good, service or construction contract.

The new standard provided more and clearer guidance which led to the contract being divided into two separate performance obligations and this resulted in a better match between revenues and expenses. The revenue for the service was recognized in the same time period as the service was performed, i.e. when the entity had the expenses. For the entity, this means that their financial statements will show a truer and fairer view.

Other effects on entities will be the additional expenses when adopting the new standard and that the extended disclosure requirements might be burdensome and costly for the entities.

8.7.4 The effect on users of financial statements

The current standards on revenue recognition are inconsistent and vague, resulting in different interpretations by entities (FASB 2008). This makes the financial statements less comparable for the users when making financial decisions. But these weaknesses will probably be decreased through improved guidance and more clarity in Revenue from Contracts with Customers. The conditions to achieve more comparability between entities are increased and this improves the base for the users when making decisions. To remove inconsistencies and weaknesses in existing revenue requirements and to improve comparability of revenue recognition are two of the purposes with the new standard (IFRS 2011, IN2).

Another purpose of the new standard is to provide more useful information to users of financial statements (IFRS 2011, IN2). To achieve this, the boards have introduced additional and more comprehensive disclosure requirements. Even though the respondents of the exposure draft believed that the extended disclosure requirements would be overly burdensome and costly to prepare (Crowley et al. 2012), they will probably help users of financial statements to understand the circumstances leading to an entity recognizing revenue. Hereby, the standard sets higher demands on entities by requiring additional information being published, resulting in greater benefits for users of financial statements.

8.8 Conclusion

Revenue recognition is a topic surrounded by difficulties and this chapter sought to describe the reasons behind the convergence project of revenue recognition between the FASB and the IASB. The main issues within their standards are their broad revenue recognition criteria and their inadequate disclosure requirements. The reasons behind the convergence project were to eliminate these issues and to make their existing financial reporting standards fully compatible.

In addition, this chapter sought to discuss how Revenue from Contracts with Customers would affect entities and users of financial statements. The new standard will facilitate for entities in many ways, i.e. by using the five-step model for all revenues and by providing more and clearer guidance. This can lead to a better match between
 revenues and expenses, resulting in a truer and fairer view of the financial statements. This will facilitate for the users when making financial decisions since the comparability between entities’ financial statements will be increased. The extended disclosure requirements will be an advantage for the users, although it might be costly for the entities. Further, the implementation of the new standard will also lead to expenses, but hopefully the benefits of Revenue from Contracts with Customers will exceed the costs.

8.9 Questions

• Describe briefly the development of revenue recognition.
• What are the main issues with the current standards regarding revenue recognition?
• What was the purpose of the Norwalk Agreement?
• What are the stated objectives of the exposure draft, Revenue from Contracts with Customers?
• Describe the five step model.
References


Internet


Revenue Recognition – the past, the present and the future


Section 5
Goodwill
Chapter 9
Management’s Possibilities to Affect Impairment of Goodwill

Sarah Bengtsson
Fridolf Gustavsson
Ann-Sofie Vedenbrant

9.1 Introduction

In 2005 new rules were introduced regarding goodwill for listed companies in the European Union (FAR, 2008). Previously, companies had to make depreciation of goodwill, which the new rules did not allow. Goodwill will now be annually tested to see if a need for impairment exists, which may lead to more true and fair information. Impairment of goodwill is treated in IAS 36 and a need for impairment occurs when an asset has decreased in value (ibid).

According to Nilsson et al (2002), there is a problem with determining the value of goodwill in an acquisition. It is up to the valuer to make a decision about how much goodwill to be impaired. The valuer will determine if the company has paid a reasonable price at the time of acquisition, or if the price that they paid was overcharged (ibid). The value of goodwill is based on judgments, which means that the company may be affected by other prevailing factors on an impairment assessment. Impairment of goodwill charges the income negatively, that leads to incentives to avoid impairment (Husmann and Schmidt, 2008).

According to Gauffin and Thörnsten (2010), impairment of goodwill does not indicate that the company is in a bad situation. It is something that is considered to be done. Companies use valuation models to determine if a need for impairment exists. Here, factors such as the choice of discount rate enable companies to influence the value of goodwill and avoid a need for impairment. If impairments are not done, the balance sheet is dominated by goodwill items (ibid). Thus, this might not always be the case.

This chapter will discuss the problem of impairment testing and how management measures if there is a need for impairment of goodwill. How significant is measurement and to what extent is there room for management to have discretion when dealing with impairment of goodwill?
After reading this chapter the reader should be able to:

• Have an insight in the structure and purpose of impairment
• Understand the problems related to impairment of goodwill
• Understand why management do certain choices, when dealing with impairment of goodwill

9.2 Disposition

The first part of this chapter will describe the impairment of assets and goodwill. Some examples of impairment of assets and goodwill will be presented to give the reader a better understanding. The following part will discuss the problem of subjective assessments, and issues relating to fair value and discounted cash flow. Further, the theories "Creativity in Accounting", "Positive Accounting Theory" and "Institutional Theory" will be explained. The last part of this chapter will discuss and analyze management’s discretion together with the theories and given examples. The questions mentioned in the introduction will be answered in the conclusion.

9.3 Definitions

This section will provide a few important definitions, which the reader needs to be familiar with to fully understand this chapter.

Active market – Exists when all the following conditions are fulfilled:
• the items traded are homogenous;
• willing buyers and sellers can usually be found; and
• prices are available to the public.

Cash-generating unit – Is the smallest identifiable group of assets that for continuous use generates cash inflows that are substantially independent of the cash inflows from other assets or groups of assets.

Fair value less costs to sell – Net selling price, the price of an asset in an active market less disposal costs.

International Accounting Standards (IAS) – Accounting standards included in IFRS.

International Financial Reporting Standards (IFRS) – Set of accounting standards developed by IASB. The goal of IFRS is to provide a global framework for how public companies prepare and disclose their financial statements.

Value in use – Is determined as the present value (discounted) of future net cash flows expected to arise from continued use of the asset over its remaining useful life and upon disposal.
Management’s Possibilities to Affect Impairment of Goodwill

9.4 Impairment of Assets

Impairment of assets is a standard in international accounting. It is a complex area with a lot of rules that companies are obliged to follow. Impairments reduce the carrying amount of an overstated asset (Doupnik and Perera, 2012).

9.4.1 IAS 36 – Impairment of Assets

Impairment of assets is treated in IAS 36, which is included as a standard in IFRS. The objective of this standard is to describe how an entity could ensure that its assets are not accounted for more than their recoverable amount (IAS 36).

When the carrying amount exceeds its recoverable amount an asset should be impaired (ibid). According to IAS 36.6, the carrying amount is defined as “the amount at which an asset is recognized after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon”. Recoverable amount is defined as an asset or a cash-generating unit choosing the highest of “its fair value less costs to sell and its value in use” (IAS 36.6).

![Figure 9.1 Terms within IAS 36](image)

According to IAS 36, a company shall each year test an intangible asset with an indefinite useful life for impairment, whether there is any indication of a need for impairment or not. This is tested, at the end of each reporting period, by comparing the tangible asset’s carrying amount with its recoverable amount. Companies should also test an intangible asset that is not yet ready for use each year by the same comparison. They must annually analyze whether there is an impairment of goodwill acquired in a business combination. When making the assessment great emphasis should be made whether the information reflects reasonable and acceptable assumptions, which form a reliable estimation of future economic conditions (ibid).

According to IAS 36, there are both external and internal indications, which the company should take into consideration if there is a need for impairment. Examples of external indications are examining whether an asset's market value has declined significantly for reasons other than the asset's age and normal use. Negative changes that have occurred within the company are related to its technology, market conditions, legal and economic environment. The company should also consider if interest rates have changed on the market or if the market rate of return on investments have changed during
the period. The last two parameters affect the discount rate used in calculating the asset's value. This can cause the recoverable amount of the asset to be reduced. Examples of internal indications for impairment is that significant changes have occurred or will occur, that adversely affect the ability to use the asset for its intended purpose. The asset may be outdated or damaged. There is also internal information that may indicate that asset returns are lower than expected (ibid).

9.4.2 Example of Impairment of Assets

The following is an example that shows how a company should proceed in an impairment test.

At December 31, Year 1, a company has assets with the following characteristics:

<table>
<thead>
<tr>
<th>Carrying amount</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$80,000</td>
</tr>
<tr>
<td>Costs of disposal</td>
<td>$2,000</td>
</tr>
<tr>
<td>Expected future cash flows</td>
<td>$110,000</td>
</tr>
<tr>
<td>Present value of expected future cash flows</td>
<td>$92,000</td>
</tr>
</tbody>
</table>

In applying IAS 36, the asset’s recoverable amount would be determined as follows:

- Net selling price: $80,000 – 2,000 = $78,000
- Value in use: $92,000
- Recoverable amount (greater of the two): $92,000

The measurement of impairment loss under IAS 36 is not complicated. Impairment loss is the amount at which the carrying amount is exceeding the recoverable amount (Doupnik and Perera, 2012).

The determination and measurement of impairment loss would be:

<table>
<thead>
<tr>
<th>Carrying amount</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recoverable amount</td>
<td>$92,000</td>
</tr>
<tr>
<td>Impairment loss</td>
<td>$8,000</td>
</tr>
</tbody>
</table>

9.5 Goodwill

According to Alexander et al (2010), goodwill is an item that may arise as a result of a purchase, in a business combination or be internally generated. If the acquiring company pays a higher amount than the acquired company’s equity, i.e., net value (the difference between assets and liabilities), the exceeded amount represents goodwill. This is because the acquired company’s assets are not recognized in the balance sheet, e.g. a general expectation of high future cash flows (ibid).
Management’s Possibilities to Affect Impairment of Goodwill

9.5.1 IFRS 3 – Business Combination

Goodwill that is measured and recognized in a business combination is treated in IFRS 3. Under IFRS 3 all companies should recognize business combinations by applying the acquisition method. They should begin with an identification of the acquirer and determine the acquisition date. Moreover, companies should implement accounting and valuation of the acquired assets that are identifiable, the debt that is assumed and non-controlling interest in the acquired company. Finally, measurement and recognition of goodwill should be made (ibid).

Goodwill is calculated as the sum of:

- the transferred compensation measured at fair value on the acquisition date;
- the amount of any non-controlling interest and the fair value at the acquisition time point for equity interests acquired through incremental acquisitions; less
- amounts at the date of acquisition of the identifiable assets acquired and liabilities assumed (ibid).

9.5.2 Impairment Testing of Goodwill Acquired in a Business Combination

Acquisitions of goodwill made by business combinations are tested for impairment under IAS 36. Goodwill arising from a business combination is seen as payments for assets that give rise to future economic benefits. It is not possible to report separately as it often contributes to cash flows of multiple cash-generating units (IFRS 3).

Goodwill is allocated mostly to groups of cash-generating units (IAS 36). Under IFRS 3 in assessing a need for impairment, goodwill acquired in a business combination is allocated to all of the acquired company’s cash-generating units expected to benefit from the synergies of the business combination (ibid).

Goodwill should at least annually or more frequently, if there are indications of depreciation, be tested if there is a need for impairment. Comparing the carrying amount of the goodwill that has been acquired with its recoverable amount tests this. If the carrying amount exceeds the recoverable amount, impairment is achieved by allocating the impairment amount. The exceeding amount is an impairment loss. First, the carrying amount of the goodwill belonging to the cash-generating unit is reduced. Then the carrying amount will be reduced proportional to the goodwill that has been derived to other assets in the unit, based on the carrying amount of each asset in the unit (ibid).

If there are indications of impairment of an asset that is part of a cash-generating unit, the entity shall review the individual asset’s need for impairment. Before the need for impairment of the cash-generating unit is reviewed by the company, this should be reported (ibid).

Reversal of an impairment of goodwill is not permitted due to that an increase in the recoverable amount is seen as an internally generated goodwill, which may not be included in the balance sheet (ibid).
9.5.3 Example of Impairment of Goodwill

The following is an example that shows how a company should proceed in an impairment test that is dealing with goodwill.

A company has assets with the following characteristics:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>$560,000</td>
<td>Costs to sell</td>
<td>$60,000</td>
</tr>
<tr>
<td>Present value (PV) of future cash flows</td>
<td>$540,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The impairment loss is determined as follows:

<table>
<thead>
<tr>
<th></th>
<th>Net assets</th>
<th>Goodwill</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount</td>
<td>$560,000</td>
<td>$240,000</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

Determination of recoverable amount:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value less costs to sell</td>
<td>$500,000</td>
<td>PV of future cash flows</td>
</tr>
<tr>
<td>Recoverable amount (greater of the two)</td>
<td>$540,000</td>
<td></td>
</tr>
</tbody>
</table>

Impairment loss (IL): $260,000

Allocation of impairment loss:

<table>
<thead>
<tr>
<th></th>
<th>Net assets</th>
<th>Goodwill</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount</td>
<td>$560,000</td>
<td>$240,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Impairment loss</td>
<td>-20,000</td>
<td>-240,000</td>
<td>-260,000</td>
</tr>
<tr>
<td>Carrying amount after IL</td>
<td>$540,000</td>
<td>$0</td>
<td>$540,000</td>
</tr>
</tbody>
</table>

9.6 Subjective Assessments

It is the business management’s assessments that will determine if there is a need for impairment. IAS 36 should be used as guidance for reducing own interpretations of impairment, which reduces subjective assessments (Marton et al, 2010). Husmann and Schmidt (2008) argue that IAS 36 opens up to measurement error due to the absence of guidelines, which can lead management to manipulate profits. Marton et al (2010) argue that there is a need for expertise in valuation since IAS 36 is a complex standard.

According to Lander and Reinstein (2003), assets were previously valued at cost, but now they are valued at market value. This has led to an increased need for values for accounting measures (ibid).
Management’s Possibilities to Affect Impairment of Goodwill

9.6.1 Fair Value

In the valuation of fair value there are three levels that companies must apply. When using level one, the result is the most reliable. In level two and three the reliability is descending (IFRS 13).

In level one, inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. In level two inputs are other than quoted market prices included within level one that are observable for the asset or liability, either directly or indirectly (ibid). In level three market-based data is not adequately available. Fair value is computed using unobservable inputs that reflect expected assumptions made by market participants and one or more valuation techniques, such as a model like the Discounted Cash Flow (DCF), which will be explained in the section below (Fornaro and Barbera, 2007). Use of fair value for impairment testing is considered to give room for different interpretations (Husmann and Schmidt, 2008).

9.6.2 Discounted Cash Flow (Value in Use)

DCF is a valuation model and is the model that most companies use to see if there is a need for impairment. DCF means that the management forecast future cash flows and discounts them to present value. One factor that may affect whether a need for impairment of goodwill exists is the choice of discount rate (Lander and Reinstein, 2003).

The discount rate should be equal the rate of return on capital of the company from its stakeholders. Considering a valuation of the discount rate when valuing goodwill, IAS 36 gives guidance on how a company should estimate this factor. Under IAS 36 the discount rate should be stated before tax in the calculation of value in use. Petersen and Plenborg (2010) argue that it is as common to use the discount rate after tax.

According to IAS 36, the discount rate should reflect current market assessments of the time value of money and assets’ specific risks. One way to get a discount factor is that claim for yield can be derived from current market transactions for similar assets. If it is not possible to determine a specific rate for the asset from the market, companies can choose to apply other alternative methods (ibid).

9.6.3 Illustrative Examples of Discounted Cash Flows

Company X is engaged in the telecommunications industry and has acquired Company Y. The business combination gives rise to an allocated goodwill of $10 000. Company X:s acquired goodwill is attributable to the synergies of the cost savings of one headquarter and of one management. Goodwill will also consist of future revenue growth from the acquired company’s customer stock and economies of scale in the production of new networks. The goodwill in the balance sheet of Company X will be tested annually for impairment by a sensitivity analysis. Company X annually assesses what the expected cash flows for eight years in the future will be. These different cash flows for the three factors are summed and discounted at the current discount rate to present value. If the present value would exceed $10 000, goodwill will not be a subject to impairment. The management bases its model on a discussion of how valuable the future cash flows of the different factors are, and the logical reasoning becomes the basis for the valuation that permeates goodwill when there is not any fair value available.
Table 9.2 Example 1 – Changes in Discount Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Synergies</td>
<td>300</td>
<td>350</td>
<td>400</td>
<td>450</td>
<td>500</td>
<td>550</td>
<td>600</td>
<td>650</td>
</tr>
<tr>
<td>Revenues from customer stock</td>
<td>400</td>
<td>600</td>
<td>800</td>
<td>1000</td>
<td>1200</td>
<td>1400</td>
<td>1600</td>
<td>1800</td>
</tr>
<tr>
<td>Economies of scale</td>
<td>75</td>
<td>100</td>
<td>125</td>
<td>150</td>
<td>175</td>
<td>200</td>
<td>225</td>
<td>250</td>
</tr>
<tr>
<td>Total cash flow</td>
<td>775</td>
<td>1050</td>
<td>1325</td>
<td>1600</td>
<td>1875</td>
<td>2150</td>
<td>2425</td>
<td>2700</td>
</tr>
<tr>
<td>Discounted cash flow</td>
<td>738</td>
<td>952</td>
<td>1145</td>
<td>1316</td>
<td>1469</td>
<td>1604</td>
<td>1723</td>
<td>1827</td>
</tr>
</tbody>
</table>

Discount rate: 5.0%

Present value of cash flows: $10,776

Table 9.2 Example 1 – Changes in Discount Rates (continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Synergies</td>
<td>300</td>
<td>350</td>
<td>400</td>
<td>450</td>
<td>500</td>
<td>550</td>
<td>600</td>
<td>650</td>
</tr>
<tr>
<td>Revenues from customer stock</td>
<td>400</td>
<td>600</td>
<td>800</td>
<td>1000</td>
<td>1200</td>
<td>1400</td>
<td>1600</td>
<td>1800</td>
</tr>
<tr>
<td>Economies of scale</td>
<td>75</td>
<td>100</td>
<td>125</td>
<td>150</td>
<td>175</td>
<td>200</td>
<td>225</td>
<td>250</td>
</tr>
<tr>
<td>Total cash flow</td>
<td>775</td>
<td>1050</td>
<td>1325</td>
<td>1600</td>
<td>1875</td>
<td>2150</td>
<td>2425</td>
<td>2700</td>
</tr>
<tr>
<td>Discounted cash flow</td>
<td>724</td>
<td>917</td>
<td>1082</td>
<td>1221</td>
<td>1337</td>
<td>1433</td>
<td>1510</td>
<td>1571</td>
</tr>
</tbody>
</table>

Discount rate: 7.0%

Present value of cash flows: $9,795

In the first example, all the three factors have exactly the same positive cash flows, but in the first case, management has motivated a discount rate of 5% and gets a current present value of $10,776. In this case, no impairment occurs when future benefits are valued higher than goodwill. In the latter case management has come up with a discount rate of 7%. This means that the present value will be $9,795, which is lower than in the first case and leads to that an impairment of goodwill should be done.
Management’s Possibilities to Affect Impairment of Goodwill

<table>
<thead>
<tr>
<th>Year</th>
<th>Synergies</th>
<th>Revenues from customer stock</th>
<th>Economies of scale</th>
<th>Total cash flow</th>
<th>Discounted cash flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>650</td>
<td>400</td>
<td>75</td>
<td>1125</td>
<td>1051</td>
</tr>
<tr>
<td>2</td>
<td>600</td>
<td>600</td>
<td>100</td>
<td>1300</td>
<td>1135</td>
</tr>
<tr>
<td>3</td>
<td>550</td>
<td>800</td>
<td>125</td>
<td>1475</td>
<td>1204</td>
</tr>
<tr>
<td>4</td>
<td>500</td>
<td>1000</td>
<td>150</td>
<td>1650</td>
<td>1259</td>
</tr>
<tr>
<td>5</td>
<td>450</td>
<td>1200</td>
<td>175</td>
<td>1825</td>
<td>1301</td>
</tr>
<tr>
<td>6</td>
<td>400</td>
<td>1400</td>
<td>200</td>
<td>2000</td>
<td>1333</td>
</tr>
<tr>
<td>7</td>
<td>350</td>
<td>1600</td>
<td>225</td>
<td>2175</td>
<td>1354</td>
</tr>
<tr>
<td>8</td>
<td>300</td>
<td>1800</td>
<td>250</td>
<td>2350</td>
<td>1368</td>
</tr>
</tbody>
</table>

Discount rate: 7.0%  
Present value of cash flows: $10006

<table>
<thead>
<tr>
<th>Year</th>
<th>Synergies</th>
<th>Revenues from customer stock</th>
<th>Economies of scale</th>
<th>Total cash flow</th>
<th>Discounted cash flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>300</td>
<td>400</td>
<td>75</td>
<td>775</td>
<td>724</td>
</tr>
<tr>
<td>2</td>
<td>350</td>
<td>600</td>
<td>100</td>
<td>1050</td>
<td>917</td>
</tr>
<tr>
<td>3</td>
<td>400</td>
<td>800</td>
<td>125</td>
<td>1325</td>
<td>1082</td>
</tr>
<tr>
<td>4</td>
<td>450</td>
<td>1000</td>
<td>150</td>
<td>1600</td>
<td>1221</td>
</tr>
<tr>
<td>5</td>
<td>500</td>
<td>1200</td>
<td>175</td>
<td>1875</td>
<td>1337</td>
</tr>
<tr>
<td>6</td>
<td>550</td>
<td>1400</td>
<td>200</td>
<td>2150</td>
<td>1433</td>
</tr>
<tr>
<td>7</td>
<td>600</td>
<td>1600</td>
<td>225</td>
<td>2425</td>
<td>1510</td>
</tr>
<tr>
<td>8</td>
<td>650</td>
<td>1800</td>
<td>250</td>
<td>2700</td>
<td>1571</td>
</tr>
</tbody>
</table>

Discount rate: 7.0%  
Present value of cash flows: $9795

Figure 9.3 Example 2 – Changes in Future Synergies

In the second example, with the same business combination and the same factors, management has decided that the discount rate should be set at 7% for the calculation of the present value of goodwill. This leads to the conclusion that the present value is $9795, resulting that impairment is necessary. Management is now beginning to consider whether the synergies from the business combination will provide the most positive cash flows in the early period and then subside. We can see in the top case of the second example, where the expected synergies have received the reverse order as opposed to the lower case. This leads to the conclusion that the present value of goodwill is estimated to $10 006 and now there is no need for impairment. Management has great influence in determining the present value of goodwill by the company's own calculation, to determine the fair value. Management’s thoughts and discussion on future high or low positive cash flows from various factors in combination with the chosen discount rate, reflects the results of the valuation of goodwill in the balance sheet.

9.7 Creativity in Accounting

According to Riahi-Belkaoui (2004), the Creativity in Accounting implies companies to do their own interpretations of accounting rules. This might result in different financial conditions that are more or less optimistic than the real conditions. “Big Bath” accounting is a part of the Creativity in Accounting (ibid).

9.7.1 Big Bath Accounting

Riahi-Belkaoui (2004) argues that management in Big Bath Accounting uses their position to take measures that control the income. They can do this when the income is lower than expected. There are various alternative measures that a company can use to
control the income. One option that arises, is whether or not a company is aware that they are going to show a loss before fiscal year ends, they can make bigger impairment on for example old projects and assets to make the income lower. If a company has profits that are not regular, they can offset high costs against these. Another option is that at low gains, companies can choose to move costs to the current period, which is barely noticeable. The advantage of the "Big Bath" is that costs that are moved to the current period lead to fewer costs in the future (ibid).

The reason that a company would reduce a negative income one year with "Big Bath" accounting is because they want to be able to show a big improvement on reported income the year after. If the company impairs an already negative income they will not be punished more than if they had not been taking any accounting measures at all. However, the company will be rewarded with better results next year (ibid).

9.8 Positive Accounting Theory

According to Watts and Zimmerman (1986), the Positive Accounting Theory (PAT) seeks to clarify and predict how a business may act when other options are given. The theory gives certain flexibility for standard setters, as they do not completely specify which accounting principle that should be applied. However, there is a risk that if the management has such flexibility they may act opportunistically. This behavior is reflected in the basic assumption that the theory is based on. This assumption means that the accounting is part of an agreement or contract between the principal and the agent (ibid). The opportunistic behavior can be explained in which way the company's management (the principal) will act on the basis of maximizing the company's profits, but also the maximization of management's personal gain (Scott, 2003).

Watts and Zimmerman (1986) has identified three scenarios in PAT; bonus plan hypothesis, debt/equity hypothesis and political cost hypothesis. They describe why a business management chooses a particular method of accounting (ibid). The bonus plan and the political cost hypothesis are defined below. The debt/equity hypothesis is excluded since it cannot be applied in the analysis in this chapter.

**Bonus plan hypothesis** - a management that has salary or bonus plan associated with them have the incentive to apply an accounting that accelerates the recognition of future income and defer expenses. This can lead management’s bonus to increase. Depending on how the bonus plan is designed incentives can take different forms. If management seeks to increase their future bonus, income will be deferred to the next period and accelerate the recognition of costs (ibid).

**Political cost hypothesis** - it is more likely for large companies to apply an accounting that reduce income comparatively with small companies. There are inconsistencies in the information between companies and their stakeholders, making it costly for stakeholders to ensure that the income is true and fair. This gives management an incentive to apply a discrete reporting of companies’ income (ibid).
9.9 Institutional Theory

DiMaggio and Powell (1983) argue that the Institutional Theory implies that a company's choice of accounting is influenced by institutional isomorphisms such as normative, coercive and mimetic. Isomorphism is a limited process that forces a company within a population to resemble other units within the population that are working at the same conditions (ibid). The coercive and the mimetic isomorphism are defined below. The normative is excluded since it cannot be applied in the analysis in this chapter.

Coercive isomorphism - occurs in a company as a result of formal and informal requests from other organizations where the business and the organizations are dependent on each other and when there are cultural expectations from society. Examples would be the requirements for reporting that a company must follow according to the law. Stakeholders’ expectations and demands will also affect the companies’ choices of accounting (ibid).

Mimetic isomorphism - arises because there is an uncertainty in the environment that gets companies to mimic other organizations. In order to reduce the uncertainty that prevails companies mimic other organizations because other organizations appear more legitimate and successful (ibid).

9.10 Summary

Impairment of assets is treated under IAS 36. The objective of the standard is to describe how an entity could ensure that its assets are not accounted higher than its recoverable amount. Goodwill is measured and recognized in a business combination and is treated in IFRS 3. Acquisitions of goodwill made by business combinations are tested for impairment under IAS 36. Goodwill should at least annually or more frequently, if there are indications of depreciation, be tested if there is a need for impairment. This is tested by comparing the carrying amount of the goodwill that has been acquired with its recoverable amount (IAS 36). IAS 36 opens up to measurement error due to the absence of precise guidelines, which can lead management to manipulate profits (Husmann and Schmidt, 2008). To see if there is need for impairment, companies can use a valuation model called DCF, where the choice of discount rate is of importance (Lander and Reinstein, 2003).

In Big Bath Accounting management uses their position to take measures that control the income (Riahi-Belkaoui, 2004). PAT seeks to clarify and predict how a business may act when other options are given (Watts and Zimmerman, 1986) and the Institutional Theory implies that a company's choice of accounting is influenced by institutional isomorphisms (DiMaggio and Powell, 1983).

9.11 Analysis and Discussion

9.11.1 Subjective Assessments

In impairment testing companies could use IAS 36 as guidance. IAS 36 should affect the companies to reduce their own subjective assessments (Marton et al, 2010). Husmann and
Schmidt (2008) argue that the guidance is inadequate because the management is given opportunities to manipulate profits (ibid). If there are opportunities to influence the amount goodwill is valued at, and thereby avoid impairment, there should be incentives to value after self-interest. The question that arises is whether management or other employees, who hold variable payments, use their discretion to influence the valuation. If they use their positions to avoid an impairment of goodwill in order to maintain a better income and a higher valuation of the company, a situation that favors their own payments may occur.

According to Lander and Reinstein (2003), goodwill is valued at market value, and it has led to a greater need for accounting valuation models. To obtain the recoverable amount companies should select the highest of fair value less costs to sell and value in use (IAS 36). Goodwill may arise from items that are difficult to value for companies and where no active market for price comparisons is available. This means that companies choose to estimate as per value in use and it may be derived from a model in which future cash flows are discounted, for example by DCF. The need for valuation models may have to do with that companies today use models in which their own discretion form the basis of the definitive value of the model. Discretion and more rules-based models should result the company not to have equal opportunities to influence the income.

IAS 36 is a complex standard and there is a need for expertise in valuation (Marton et al, 2010). The complex standard requires employees who possess the right competences and experiences for a proper implementation and estimation. Allowing employees to participate in education can lead to a greater knowledge. Alternatively, the company may hire expertise for difficult valuation cases, which can be regarded as a costly but impartial valuation. Large companies with many employees may have more expertise compared to a smaller company. It can lead to increased opportunities for a more accurate enforcement of accounting standards and valuation under IAS 36.

### 9.11.2 Fair Value

According to IFRS 13, fair value is based on three levels. If there are no current market prices for homogenous or similar goods, an entity shall measure fair value based on a valuation model (ibid). Husmann and Schmidt (2008) argue that use of fair value for impairment testing is considered to give room for different interpretations (ibid). Companies’ management can argue that their product is unlike other products on the active market and therefore no comparison can be attributed to their product. They can therefore choose to justify for example, by use of DCF according to the third level, in order to estimate their product. The product will then be valued based on the present value of expected future cash flows. Companies may want to do an estimation based on the third level, for them to get the opportunity to make a greater valuation of the asset. Discretion and own reasoning about future income is the basis for valuation.

### 9.11.3 Discounted Cash Flow

Lander and Reinstein (2003) argue that one of the possibilities to value goodwill is to use DCF, which is a model for calculating the present value of future cash flows. The model summarizes the cash flows and then they are calculated at the current present value discounted by a discount rate. The choice of discount rate controls if there is a need for
impairment (ibid). Example 1 of the "X.6.3 Example of valuation models" shows that the choice of discount rate has a great deal in the income of the discounted cash flows. Two percentage points difference in the discount rate may be the difference in whether a need for impairment of goodwill exists. It can be considered that there should be a specific guidance on how the discount rate is determined.

The discount rate should reflect current market assessments of the time value of money and the specific risks of assets (IAS 36). Market assessments of the time value of money should be set as inflation targets in the country where the company operates. To assess an asset's risk should be more problematic because it requires own assessment of the risks that exist and how great the risk is. According to IAS 36, companies can choose to apply other methods when it is not possible to determine a specific rate for the asset from the market (ibid). In the current situation, it is up to the management itself to choose the discount rate. This requires a statement of the company's estimated market risk. This leads to the possibilities for manipulation that could lead to a desired income on the present value.

Even if management chooses not to justify a specific discount rate, there are other things that can change the discount rate. Under IAS 36, the discount rate should be stated before tax. However, it is common for companies to use the discount rate after tax according to Petersen and Plenborg (2010). Depending on whether the discount rate is before or after tax rate may vary a few percentage points. As the discussion above, the choice of discount rate may control if there is a need for impairment or not.

9.11.4 Big Bath

Big Bath Accounting may be one of the reasons that company’s management consciously choose to adjust the discount rate to achieve a desired income. According to Riahi-Belkaoui (2004), Big Bath Accounting means that management chooses to achieve a reduction in income one year, and then next year achieve better income and thereby incurring fame for fast recovery (ibid). Management can make an impairment of goodwill to reduce net income, such as the motivation to use a higher discount rate. This can lead to a need for impairment of goodwill to arise. They can also choose to let the discount rate remain at a lower level and then adjust its forecast of future cash flows accruing to goodwill in the balance sheet. This enables the company to produce a value in use that is less than the carrying value, and thus, impairment occurs.

To control the income in this way can also be related to variable payments as high-ranking employees can assimilate. Therefore, there is an incentive for some people to influence accounting when there are connections to employees’ wages and bargaining power in future pay negotiations. Riahi-Belkaoui (2004) argues that if a company has profits that are not regular, they can offset the high costs against these (ibid). Trying to control the income may have a basis in the tax burden on the company. Management may have a desire to do impairment one year when they have a high income, to avoid paying too much tax.

If a company chooses to impair goodwill to decrease its income, they should keep in mind that goodwill that has been impaired cannot be written up. Under IAS 36 a reversal of an impairment of goodwill may not occur because an increase in the recoverable amount is seen as an internally generated goodwill, which may not be included in the balance sheet.
9.11.5 Positive Accounting Theory

There is a hypothesis in PAT called the Bonus plan (Watts and Zimmerman, 1986). This hypothesis resembles of Big Bath Accounting involved in the above discussion. Like the previous reasoning, that management within a company may have an opportunity to influence the income through their own assessments of the valuation of certain items, there should be an incentive to get management to control the income. Watts and Zimmerman (1986) argues that a management that has salary or bonus plan associated with them has the incentive to apply an accounting that accelerates the recognition of future income and defer expenses (ibid). Management may, by keeping up a high valuation on big goodwill items, avoid an impairment of these and thereby postpone a cost that could burden the income. The question is whether companies applying variable payments or bonuses linked to income more often choose to affect the valuation models to achieve a higher income. Benefits linked to the own individual may be a stronger driving force to be drawn into a project that seeks to influence the income.

In another hypothesis called Political cost it is more likely that large companies apply an accounting that reduces income comparatively to small companies (ibid). Large companies tend to have more resources and probably more well educated and competent employees who can construct their own models for sensitivity analysis. Larger companies may have more authority and driving force, and thereby, their models become more accepted by authorities and shareholders. A smaller company could construct a model for valuation but they might be more contested by the authorities and may need a stronger argumentation for their opinions and judgments. Large companies tend to decrease the income and may have more incentives to adjust their models to make impairment or extended impairments the year when the company is expected to get a high profit.

9.11.6 Institutional Theory

In the Institutional Theory there is one isomorphism called Coercive, which means that the company's choice of reporting can be controlled by formal and informal expectations and demands from other organizations (DiMaggio and Powell, 1983). When companies are pressured from outside organizations on how to act in matters concerning accounting and income, they may feel coerced to adopt a certain method to achieve a desired income. Stakeholders and shareholders can urge on bigger companies to act in a certain way in order to maximize their own returns. They may have a desire to get companies not to impair goodwill when decreasing income. If the company is making big profits, they will be able to portion out bigger dividends to shareholders. According to DiMaggio and Powell (1983), one example of coercive isomorphism is that companies must follow the law that exists (ibid). Under IAS 36, a company must annually assess whether there is a need for impairment (ibid). There is a law that coerces companies to annually monitor goodwill on the balance sheet to make sure they are not incorrectly valued. This can be considered good, but given that the assessment of fair value often is applied through a model that companies construct and apply by themselves, the law could lose its relevance. Conceivably, the law should be more rules-based and emphasized on how companies should estimate more difficult items that have no current market values, like goodwill. It is also conceivable that there would be a more consistent and fair reporting if there were options or discretions for different applications in the IAS. A larger company with sound values and a true and fair accounting based on observations and assessments
Management’s Possibilities to Affect Impairment of Goodwill

that are easy to understand would become a good example for other companies in the same industry.

If a company is coerced by its stakeholders to keep profits, other companies may feel coerced to mimic their approach and apply similar methods. DiMaggio and Powell (1983) argue that an uncertainty in the environment gets companies to mimic other organizations. Mimetic isomorphism describes how companies choose to mimic each other because organizations appear more successful (ibid). If a company makes a business combination of a subsidiary in a particular industry and chooses to allocate goodwill related to the acquisition in a certain way, it is possible that similar companies mimic and imitate their approach. The mimetic logic can have a negative impact if the company only requires another company to do the right thing in every situation and that is not linked to their own business.

9.12 Conclusion

Management uses valuation models to identify if a need for impairment exists. The problem with impairment testing is that companies and organizations can apply different valuation models. The valuation models can lead to different outcomes, which can determine if there is a need for impairment of goodwill or not. Measurement is therefore an important part of the basis for valuation.

It is possible for management to have discretion, since the various valuation models is based on various factors, which are given the opportunity for their own justifications. The factors may include discount rate, expected future cash flows and recognition of revenues.

The following model is designed to show how a company’s management through discretion can control and influence the final present value of an asset at the DCF valuation. Thus, a management may influence whether there is a need for impairment or not.

<table>
<thead>
<tr>
<th>Management’s Possibilities to Affect Impairment of Goodwill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argue for a lower discount rate</td>
</tr>
<tr>
<td>Argue for bigger cash flows</td>
</tr>
<tr>
<td>Argue for earlier recognition of income</td>
</tr>
<tr>
<td>Argue for improved cash flows in the future</td>
</tr>
<tr>
<td>▼▼▼</td>
</tr>
<tr>
<td>Higher present value</td>
</tr>
<tr>
<td>▼▼▼</td>
</tr>
<tr>
<td>Avoid impairment</td>
</tr>
</tbody>
</table>

Figure 9.4 Management’s possibilities to affect impairment of goodwill.
9.13 Questions

- How do you measure if there is a need for impairment?
- How often do you need to test if there is a need for impairment?
- What is goodwill?
Management’s Possibilities to Affect Impairment of Goodwill

References


Chapter 10
Core and Complexity of Goodwill

Julia Färnemyhr
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10.1 Introduction

The growing significance of intangible assets and goodwill has become a fact in the current economic development, especially for entities operating in high technology industries (Jerman & Manzin, 2008). Goodwill is one of the most difficult items under the International Financial Reporting Standards (IFRS), particularly when it comes to the impairment test. The treatment of goodwill is not a new phenomenon, though it has been discussed for over a century (Marton, 2011). Different methods have been used and debated, but all of them are problematic in some way. Today all identifiable intangible assets in an acquisition have to be recognized on the balance sheet separately (Jerman & Manzin, 2008); it is only the residual and unidentified asset that is allowed to be recognized as goodwill. It is not allowed to recognize internally generated goodwill.

In the beginning of the twenty-first century new standards, regarding goodwill accounting, were introduced by the Financial Accounting Standards Board (FASB) and a few years later by the International Accounting Standards Board (IASB), as a move towards international convergence (Jerman & Manzin, 2008). According to IFRS, all business combinations initiated after March 2004 must be accounted with the acquisition method (IFRS 3, 2012) and goodwill has to be tested for annual impairment (IAS 36, 2012).

The intent of the impairment approach to goodwill was to improve the information content of reported acquired goodwill and to reduce the managerial flexibility that former standards allowed (AbuGhazaleh, Al-Hares & Roberts, 2011). Earlier, entities had to amortize capitalized goodwill, which resulted in big amortizations and low results (Marton, Lumsden, Lundqvist, Pettersson & Rimmel, 2010). The reason for removing the traditional amortization method was that this accounting practice did not contain any information value for those using the financial reports (Wines, Dagwell & Windsor, 2007). The new standards provide a consequent recognition of goodwill and other intangible assets, which is necessary in this global world (Jerman & Manzin, 2008).

IFRS 3 (2012) requires the acquirer to disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that occurred during the current reporting period or after the reporting date, but before the
financial statements are authorized for issue. After a business combination, the acquirer must disclose any adjustments recognized in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods. According to Marton (2011) the IFRS 3 has been largely criticized and the entities seem to have difficulties in applying the standard, because the area is often mentioned among significant judgments and uncertainties in the financial statements. The fair value component of impairment test is considered to create opportunities for interpretations, which causes subjective assessments that the management can take advantage of (AbuGhazaleh et al., 2011).

The criticism for fair value does not only concern the standards (Laux & Leuz, 2009). The big problem arises when the standards are implemented and used though the interpretations of the rules are affected by other factors and incentives. From a user perspective there are evident difficulties to compare entities even in the same industry because managements’ estimates differ substantially (Gauffin & Thörnsten, 2010). This raises questions about what goodwill really is and if it is too complex to be informative and relevant to the users. The aim of this chapter is to investigate the core of goodwill and specially to analyze the usefulness of the information received in the financial reports. The questions at issue are:

- What is the core of goodwill?
- Why is goodwill reporting complex?
- What are the alternatives to current goodwill accounting?
- How important is disclosure to the users of the financial reports?

After reading this chapter the reader should be able to understand the complexity of goodwill accounting and have a deeper knowledge of the relevant standards. The reader should also have insight into the importance of the information disclosed in the financial reports.

10.2 Disposition

At the beginning of the chapter you will find several definitions that can be useful to understand the following sections. Two relevant standards that regulate the accounting of goodwill and impairment losses are briefly summarized, and thereby complemented by the general debate of this topic. The next section presents relevant theories, which will help answering the previously stated questions in the analysis.
Core and Complexity of Goodwill

10.3 Definitions

<table>
<thead>
<tr>
<th>Accountant</th>
<th>The practitioner of accounting.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>An asset is a resource controlled by an entity as a result of a past event, and from which future economic benefits are expected to flow to the entity.</td>
</tr>
<tr>
<td>Cash-generating unit (CGU)</td>
<td>A cash-generating unit is the smallest identifiable group of assets that generates cash flows that are largely independent of the cash inflows from other assets or groups of assets.</td>
</tr>
<tr>
<td>Fair value</td>
<td>Fair value is 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.</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.</td>
</tr>
<tr>
<td>Intangible asset</td>
<td>An intangible asset is an identifiable non-monetary asset without physical substance.</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.</td>
</tr>
<tr>
<td>Value in use</td>
<td>Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.</td>
</tr>
</tbody>
</table>

Figure 10.1 Relevant definitions according to IFRS (2012).

10.4 Goodwill accounting

This section will focus on the accounting regulations by IASB, whose standards are principle-based, according to Deegan and Unerman (2011). Principle-based standards tend to be less detailed and more concise.

10.4.1 Goodwill in general

Goodwill is covered by IFRS 3 Business Combinations and is more closely described under the section concerning acquired goodwill. IAS 38 Intangible Assets provides accounting rules for purchased intangible assets, intangible assets in a business combination and internally generated intangible assets (Doupnik & Perera, 2011). According to IAS 38 p. 48-50, internally generated goodwill shall not be recognized as an asset. This type of goodwill is not recognized because it is not an identifiable resource controlled by the entity that can be measured reliably at cost. Marton et al. (2010) states that IAS 38 does not allow internally generated goodwill to be capitalized, because in retrospect it would be impossible to separate acquired goodwill from internally generated.
10.4.2 Acquired goodwill

The objective of IFRS 3 is to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects (IFRS 3.1). To accomplish this – concerning goodwill – IFRS 3 establishes principles and requirements for how the acquirer recognizes and measures the goodwill acquired in a business combination.

Earlier, entities had to choose between two methods regarding the accounting of business combinations, the pooling of interest method and the acquisition method (Marton et al., 2010). According to the acquisition method, assets and liabilities of the subsidiary should be valued at fair value at the acquisition date, while there is no revaluation in the pooling of interest method. In the US many entities classified acquisitions as mergers and could therefore use the pooling method where no goodwill occurred. This made FASB suspect that the transactions were not reported in a correct way. The difference between the two methods led to difficulties in comparing financial statements and affected the competition in the market for mergers and acquisitions (Jerman & Manzin, 2008). To resolve these problems the standard setters made significant changes concerning goodwill accounting.

10.4.2.1 The acquisition method

The acquisition method is applied when an entity account for a business combination (IFRS 3.4-5). This method requires recognizing and measuring goodwill. A number of accounting issues are associated with acquisitions (Marton et al., 2010). An important question is price paid for the acquired entity. The basic principle states that the price should be valued at fair value at the time of acquisition and that it is the cost of the acquired entity.

The acquirer shall, as of the acquisition date, recognize separately from goodwill the identifiable assets (IFRS 3.10). The assets and the liabilities that would be recognized needs to satisfy three conditions (Marton et al., 2010).

- They need to be identifiable (which is problematic with intangible assets),
- They need to satisfy the conditions of assets and liabilities under the framework, and
- They must be a part of the acquisition and cannot be handled as separate transactions.

The measurement principle states that fair value is used (IFRS 3.18). According to Marton et al. (2010) the guidance of valuation in IFRS 3 is very limited and instead the standard refers to another applicable standard. A problem is that many other standards lack this kind of guidance.

For both recognition and measurement there will be a difference from the acquired entity’s balance sheet (Marton et al., 2010). Some of the internally generated assets, for instance, may not be included on the balance sheet of the acquired entity but could be acquired assets from the perspective of the concern. The basic idea in IFRS 3 is simple and evident even though the practice is difficult.

IFRS 3 p. 32 states that goodwill shall be recognized as the excess of (a) over (b) below:
Core and Complexity of Goodwill

a) The aggregate of:

I The consideration transferred measured in accordance with this IFRS (generally fair value)

II The amount of any non-controlling interest in the acquiree

III In a business combination achieved in stages, the acquisition-date fair value of the previously held equity interest.

b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed.

10.4.2.2 Disclosure

IFRS 3 p. 59 states that the acquirer shall disclose information that enables users of its financial statements to evaluate the nature and the financial effect of a business combination. The standard requires the acquirer to disclose certain information (IFRS 3.B64). The acquirer shall disclose a qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, intangible asset that do not qualify for separate recognition or other factors. The total amount of goodwill, that is expected to be deductible for tax purposes, shall also be disclosed. If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. Regarding the term impracticable, there is a definition found in IAS 8.5. This states that applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

10.4.2.3 The nature of goodwill

Traditionally, goodwill has been seen as the present value of making extra profits in the future and the approach of IFRS is that assets included in the acquiree generate these profits (Marton et al., 2010). Because of the going concern element the acquired entity is expected to generate higher return, compared to building a new business from start. There are also synergies because some things can be produced to a lower price and more efficient when the acquired entity is combined with an acquirer.

Drefeldt (2009) discusses if the goodwill posts instead would be called line for errors and omissions in the financial statements and wonders if it really reflects extra future profits, or if it is just a hope of good returns. Drefeldt is also questioning that IASB assumes that there are measurable values for what goodwill consists of. Theoretically this is true, but Drefeldt is hesitant to the fact that entities really know what goodwill consists of. She believes that goodwill in many cases could be a dream of extra future profits, instead of a pure calculation.

Paying too much in an acquisition can have serious implications. Even though such things as a management team, or a location, may afford the acquired entity unique characteristics that are not valued on its balance sheet (Churyk & Cripe, 2011). An overpayment might be a signal of management being weak or inefficient. It may also indicate a breakdown in the principal-agent model, which later will be explained in the theoretical approach section of this chapter. Managers may understand that the new entity could give them increased power or job opportunities, for example. If managers make
acquisitions with their own interest in mind, rather than the interest of the stakeholders, it is likely that they will pay too much and ignore economic reality. Goodwill could also result from bids founded on value estimates that are inappropriate or on a mistaken belief on the ability to manage this new entity. Goodwill is only a legitimate asset if it represents the price paid for future value; in all other cases it should not be capitalized.

Gauffin and Nilsson (2011) studied the distribution of the purchase price between tangible assets, intangible assets and goodwill. They found a great diversity between the entity’s treatments. Many entities reported either the whole allocation amount as goodwill, or this amount was allocated to specific assets and no goodwill at all was recognized. Reporting the entire surplus as goodwill could be explained by limited efforts by entities acquiring small businesses.

According to Malmqvist (2009), the distribution of other intangible assets in the acquisition method is completely incomprehensible. He has not met anyone who can explain how it is calculated. Malmqvist claims that few analysts would protest if the phenomenon was terminated and instead all intangible value was allocated to goodwill. This would lead to more focus on the impairment test. One complication is that the acquired goodwill often is added into a business that has grown organically and therefore actually has a small percentage reported goodwill. The effect is that the business’ "old" income/cash flow is allowed to be the basis for impairment testing of the newly acquired goodwill. This prevents the evaluation of completed acquisitions.

10.4.3 Subsequent recognition and measurement

There are several potential ways to recognize goodwill after the initial recognition. The current treatment of IFRS is annual impairment testing which generates impairment losses if the asset’s value has decreased. Other used methods are capitalization with amortization, capitalization without amortization, and write-offs against equity (Marton et al., 2010).

10.4.3.1 Impairment test

The new IAS 36 Impairment of Assets was issued in 2004 as a part of the development of IFRS 3 (IAS 36.IN1 -4). The changes that have been made are primarily concerned with the impairment test for goodwill. The objective of IAS 36 is to prescribe that the assets of an entity are carried at no more than their recoverable amount (IAS 36.1), which shall be estimated if there is an indication that the asset may be impaired (IAS 36.66). As seen in figure 1 below, the recoverable amount is the higher of an asset’s or a cash-generating unit’s (CGU’s) fair value less costs to sell (net selling price) and its value in use (IAS 36.18). Concerning CGUs, an annual impairment test is also required at the same time every year (IAS 36.96). A CGU is formed if the recoverable amount of an individual asset cannot be determined (IAS 36.68). It is defined by the lowest aggregation of assets that generate largely independent cash inflows. Goodwill does not give rise to cash flow independent of other assets and often contributes to cash flows of many different CGUs (Marton et al., 2010). That is why goodwill never can be subject to a single impairment test; instead it is handled as a part of the CGU it belongs to. Goodwill acquired in a business combination shall be allocated to CGUs where synergies are expected for the purpose of impairment testing (IAS 36.80).
An impairment loss shall be recognized for a CGU if the recoverable amount of the unit is less than the carrying amount (IAS 36.104-107). First, the carrying amount of any goodwill allocated to the CGU is reduced. Then, the other assets of the unit are reduced proportionally based on the carrying amount of each asset in the unit. The impairment loss of goodwill will remain impaired regardless of future development; goodwill impairment can never be reversed (IAS 36.124).

10.4.3.2 Disclosure

Every year a statement must be submitted including all important assumptions made for the impairment test of goodwill and other intangible assets (Jerman & Manzin, 2008). They should be published even though no impairment has been made. It could be difficult for entities to show transparency and leave all assumptions necessary and in the same time preserve the entity’s secrets. Some key examples of all the required disclosures for impairments are presented below.

According to IAS 36 p. 130 an entity shall disclose the events and circumstances that led to the recognition of the impairment loss as well as the amount of the loss. For individual assets the nature of the asset shall be disclosed, while CGUs require a description of the units. Concerning the calculation of the amount, the entity has to specify whether the recoverable amount is the fair value less costs of disposal or the value in use. In cases when the value in use is used, the entity also has to state the discount rate in the current estimate as well as previous estimates, if there are any. In IAS 36 p. 134 entities shall for each CGU disclose the carrying amount of goodwill allocated to the unit. If the value in use is used, the assumptions on which the cash flow are based and a description of the management’s approach shall also be disclosed. If the fair value less costs of disposal is used instead, the valuation technique has to be specified.

10.4.3.3 Practice

A study made by Petersen and Plenborg (2010) shows that some entities do not follow IAS 36 when determining the CGUs and there is a great variety in the way they are
determined. For the users this complicates comparison of accounting data and ratios between entities. Corporate assets must be allocated to the CGUs and this might be difficult to do in “a reasonable and consistent way”. Because of this, it is likely that entities pass the allocation. When it comes to the estimation of fair value, the market price is often not available for many units to which goodwill are allocated (Jerman & Manzin, 2010). Then the estimates of fair value should be based on the best available information, such as prices for similar assets and liabilities or different valuation techniques. Both subjectivity and uncertainty are likely to increase and this is expected to reduce the information’s usefulness.

Louder than words is a discussion paper, concerning reduction of complexity in corporate reporting, published 2009 by the Financial Reporting Council (FRC). The main objective was to address the growing concerns about the increasing complexity and decreasing relevance of corporate reports. There are concerns about the increasing length and detail of annual reports and the regulation that govern them. The paper proposes guiding principles for regulation and communication and aims to stimulate a worldwide debate. The FRC believes that the regulation should be targeted, proportionate, coordinated and clear. To make the communication in reporting effective the reports should be focused, open and honest, clear and understandable, and interesting and engaging.

According to AbuGhazaleh et al. (2011) standard setters mean that managers will use the new introduced discretion to convey their private information on future cash flows and the suggested result would be impairments that are more reflective of the underlying economics of the entity. The study by the authors shows that managers are exercising discretion in the reporting of goodwill impairment following the adoption of the new IFRS 3. The results also indicate that there is a strong connection between effective governance mechanisms and goodwill impairment, which suggests that managers use the discretion efficiently to communicate their private expectations about the entity’s underlying performance rather than acting opportunistically. Effective governance mechanisms restrict the ability to report impairments that differ from forecasted economic losses and this would result in more timely impairments.

After the financial crisis, which started in 2008, the goodwill posts were not as volatile as expected and the entities were unwilling to take the cost of losses (Grefberg, 2009). The accounting of goodwill has no impact on the long-term corporate value. Though, in short term, dividends and profits are limited.

Gauffin and Thörnsten (2010) have studied how Swedish listed entities reported impairment in 2009. 40 entities made impairment at a total value of 11.9 billion dollars, which is about 2 % of the total goodwill post. This can be compared to the impairment made in 2008 during the global finance crisis. At this time, 37 entities made impairments of 10.2 billion dollars, which is 1.5 % of total goodwill. Some explanations to the impairment are that parts of the operations have closed, the recession or that the management has a more conservative approach to the business compared to previous years. A more profound reasoning and explanation to the impairment is however missing. From a user perspective there are evident difficulties to even compare entities in the same industry because managements’ estimates differ substantially. In the example below it is quite easy to see the different judgments being made by managers, but that is however not always the case. Today it is very difficult, sometimes impossible, to assess entities’ impairment tests based on the information provided.
A study made by two students shows a lack of disclosure concerning goodwill (Andersson & Johansson, 2010). They studied 172 entities listed at the OMX Stockholm Stock Exchange through their financial reports and selective interviews with entity representatives and financial accounting expertise. They found the information in the financial reports insufficient concerning the accounting for goodwill. In most cases the required information according to IFRS were disclosed, but there was not any detailed information. This was obviously a part of the entities’ secrets and the students conclude that there is a lack of transparency in the accounting.

### 10.4.3.4 Alternative practice

An alternative practice is treating goodwill as an asset to be amortized over its useful life. The former standard IAS 22 Business Combinations stated that the useful life of goodwill could in rare cases exceed 20 years (IAS 22.44). Normally, the amortization was on a straight-line basis (IAS 22.50). In July 2009, IASB published IFRS for SMEs, which is a stand-alone simplified standard for small and medium-sized entities (IASB, 2012). According to this standard, the acquirer in a business combination shall measure goodwill at cost less accumulated amortization and accumulated impairment losses (IFRS for SMEs 19.23). If the useful life cannot be estimated reliably it shall be presumed to be ten years.

In the UK the first standard regulating goodwill, SSAP 22 Accounting for Goodwill, was introduced in 1984 and required goodwill to be either capitalized and amortized over an “appropriate” period or written off against reserves (AbuGhazaleh et al., 2011). Because it permitted two different treatments of goodwill the standard was heavily criticized. This led to a new standard requiring goodwill to be capitalized and amortized over useful economic life, although not exceeding 20 years. In the US the amortization period was accepted up to 40 years according to the APB Opinion No 17 (Nobes & Parker, 2010). Amortization has also been used in Australia (Wines et al., 2007). Before 2005, the maximum amortization period was 20 years but there was no explanation to this period of time.

Amortization of goodwill is seemed to be arbitrary but it is easy to apply in comparison to the impairment test (Petersen & Plenborg, 2010). The major benefit of amortization is that it is possible to predict its impacts on earnings with greater accuracy.
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It is only possible to determine “normalized” or “permanent” income as a measure of earnings power by systematic amortization.

However, there is no clear evidence of any association between goodwill amortization and share values (Wines et al., 2007). The goodwill impairment test will be operational and will adequately capture any decline in value of goodwill in a more meaningful manner than the previous accounting treatment. From a balance sheet perspective, the valuation of goodwill will be more closely aligned to a real assessment of asset value. From an income statement perspective, any recognition of a loss as a result of a write-down in the valuation of goodwill will be more closely aligned to a real economic decline in value.

According to Wines et al. (2007) Australian entities were potentially disadvantaged in comparison to overseas entities not subject to the amortization period of 20 years. It is feasible that goodwill that arose from the acquisition could still be wholly or partly intact, even though the amortization treatment would result in a nil balance for goodwill. On the other hand, goodwill could not be capitalized indefinitely, which reduced the possibility for creative accounting.

The Swedish Financial Reporting Board (RFR) has responded on EFRAG’s Questionnaire on goodwill impairment and amortization and states that the treatment of goodwill should be changed from impairment testing to amortization, because systematic amortization provides an appropriate balance between conceptual soundness and practicality at an acceptable cost. They do not believe that the deficient impairment models, which leads to that recognized goodwill amounts cannot be verified, could be changed to solve the problems. It is not easy to find correct useful lives for goodwill, but amortization will lead to goodwill eventually being expensed. A review of the disclosures is also required since the current requirements are numerous.

Gauffin & Thörnsten (2010) discuss alternatives for goodwill accounting in the future. They suggest three solutions to the problem; (1) even more information, especially in the consolidated financial statements, (2) a return to amortization of goodwill or (3) something in between where amortization is necessary as long as the contrary cannot be proven.

10.5 Theoretical approach

The following theories concern different images of accounting with the main focus on the view of accounting as an information system and the characteristics that create usefulness for decision makers according to the conceptual framework. This theoretical approach will be used in the analysis and discussion section to answer the questions posed in the introduction of this chapter.

10.5.1 Different images of accounting

There are several images of the accounting process that have shaped the development of the accounting theory (Riahi-Belkaoui, 2004). According to Davis, Menon & Morgan (1982) the one of numerical reality has been most important. Accountants generally take the concept of number as an objective, value-free phenomenon. However, the use of numbers to depict various aspects of an organization rests on an important act of social construction because by using numbers we abstract from a more concrete reality. The
numbers are made to stand for the reality and the reality is interpreted through the numbers. The idea that reality can be defined through number defines the basic framework of accounting and provides constrains upon accounting. Only what is quantifiable in terms of numbers is objective and real. This image of numerical reality has especially shaped the financial accounting. Other images that have shaped the development of the financial accounting are the images that treat accounting (1) as a historical record, (2) as a descriptor of current economic reality, (3) as an information system, and (4) as a commodity. These four principal images will be further explained below.

10.5.1.1 Historical record and current economic reality

Historically, accounting has been seen as a way of providing history of an organization and its transactions with the environment (Riahi-Belkaoui, 2004). The accounting records provide a description of the manager’s stewardship of the owner’s resources and this stewardship concept is a function of the principal-agent relationship.

When accounting is viewed as a means of reflecting current economic reality, both the balance sheets and the income statements should be based on a valuation basis that better reflects the economic reality than historical costs (Riahi-Belkaoui, 2004). The method with a focus on current and future prices is seemed to reflect this economic reality in the best way. The main objective is to determine the true income for a period of time, which is reflected as the change in wealth of the entity.

Whittington (2008) created two different approaches, The Fair Value View and The Alternative View (Deegan and Unerman, 2011). The aim with financial accounting under the Fair Value View is to provide information based on future cash flows for financial stakeholders. The Alternative View, “stewardship”, is defined as accountability to present shareholders. Fair value provides information suited for a decision usefulness role whereas historical cost accounting provides information aligned to a stewardship role.

10.5.1.2 Information system

According to Riahi-Belkaoui (2004), accounting has always been viewed as an information system and this image of accounting has a superior position. The image reflects the importance of “usefulness”, the rationale for accounting data is seen as resting in the needs of the users and exists just because there are users who need the information (Davis et al., 1982). The information system is assumed to be a process that is connecting an information source (commonly the accountant), a channel of communication and a number of receivers (external users), as described in figure 10.4.
The accountant is responsible for selecting certain stimuli from the environment and communicating these to external users (Davis et al., 1982). One of the implications of the image is that since channels of communication are restricted when it comes to capacity, the accountant must choose which information to transfer on the basis of its usefulness to receivers. This leads to the importance of developing a hierarchy of the qualities that make information useful.

The type of information that are likely to be the most useful to investors, lenders and other creditors is identified in the conceptual framework (CF QC1). For the financial information to be useful there are several characteristics that need to be fulfilled (CF QC4). The most fundamental are relevance and a faithful representation and the information has to meet them both to be useful (CF QC17).

- **Relevance**: Information is relevant if it has the ability of making a difference in the decisions made by the users (CF QC6). The information is capable of making a difference if it has predictive value, confirmatory value or both (QC7). The value is predictive if it can be used as an input to processes employed by users to predict future value (CF QC8) and is confirmatory if it provides feedback about previous evaluations (CF QC9). These two aspects are interrelated; if information has predictive value it often also has confirmatory value (CF QC10).
- **Faithful representation**: To be a perfectly faithful representation a depiction would have the three characteristics *complete*, *neutral* and *free from error* (CF QC12). A depiction is complete when it includes all the information a user needs to understand the phenomenon depicted (CF QC13). A neutral depiction is free from bias in the
selection or presentation of financial information, it is therefore not slanted, weighted, emphasized, de-emphasized or in another way manipulated (CF QC14). To be faithful, the representation does not have to be accurate in all respects (CF QC15). Free from errors refers to no errors or omissions in the description of the phenomenon. It also means that the process used to produce information has been selected and applied with no errors in the process.

Comparability, verifiability, timeliness and understandability are seemed to enhance the usefulness of relevant and faithfully represented information (CF QC19).

- **Comparability**: Information is more useful if it can be compared with similar information from other entities and with similar information from the same entity but from another period of time (CF QC20). Comparability enables users to identify and also understand similarities and differences among items (CF QC21). Consistency helps to achieve comparability and refers to the use of the same methods for the same items (CF QC22). Comparability is not the same as uniformity because like things must look alike while different things must look different (CF QC23).

- **Verifiability**: Verifiability refers to that independent observers with different knowledge could reach consensus that a specific depiction is a faithful representation, although not necessarily a complete agreement (CF QC26). The quantified information need not to be a single point estimate to be verifiable, a range of possible amounts could be verified. Some explanations and forward-looking financial information may not be possible to verify until a future period, if verified at all (CF QC28). To help the users, disclosure of the underlying assumptions, the methods of compiling the information and other factors is normally necessary.

- **Timeliness**: For timeliness information need to be available to decision-makers in time to be capable of influencing their decisions (CF QC29). Older information is generally to be considered less useful.

- **Understandability**: Information is understandable if it is classified, characterized and presented clearly and concisely (CF QC30). Some complex information cannot be made easy to understand (CF QC31). The information might be easier to understand if such information is excluded from the financial reports, but this would lead to incomplete reports that are potentially misleading. Financial reports are prepared for users with a reasonable knowledge of business and economic activities (CF QC32). At times, however, even those users may need to seek aid of an adviser to understand information about complex phenomena.

The information systems image of accounting encourages the accountant to know how the user uses or processes information (Davis et al., 1982). With this in mind the sender can adjust both the frequency and the speed of the transferred information, but also the redundancy and the form. Different users have different information processing characteristics, which make the problem even more complex. The receiver will not always receive all of the communication because there could be “noise” disturbing (Parment, 2008). There is a possibility that even a clear message can be distorted because of other information. Lack of attention is another reason why all of the information does not reach the receiver. Response refers to the reaction of the receiver, which is the objective of the sent message, and feedback is when the reaction is transferred to the
sender. For the process of communication to be effective the process of encoding must be consistent with the receiver’s process of decoding.

The issue of “information overload” is often addressed in research (Deegan & Unerman, 2011). Snowball (1980) has found that an increase in information can improve the decision-making quality to a certain point. Beyond this point introduction of new information can lead to less quality in the decisions made by users.

10.5.1.3 Commodity

The last image that is the most relevant is that of accounting as a commodity where the production of accounting information is seen as economic activity (Davis et al., 1982). The information is viewed as an economic commodity with a demand and a supply. Accounting information is generated as long as this demand and supply exists. If accounting information is a public commodity, it may need to be regulated for better allocation of resources in the economy. This leads to the rationale for the standard setting bodies’ existence. By weighing the public benefit of the information against the private cost to produce it, the bodies would decide on appropriate disclosure policies.

The regulators have a big responsibility making judgments about information needs. Since it is costly to produce the information there is a problem regarding who should bear these costs and under what circumstances such costs can be referred to the supply side. Because of this, in determining the nature of accounting information, it becomes necessary to measure costs and benefits, and sometimes to search for a substitute measure of benefits. This image highlights the cost-benefit approach and consideration is made of the cost of providing information. There is also a focus on the trade-offs made between accounting users with different needs as well as trade-offs between information qualities like reliability, relevance and understandability.

10.5.2 Agency theory

An agency relationship arises when there is a contract under which one part (the principal) engages another part (the agent) to perform some services on the behalf of the principal (Godfrey et al., 2000). The principal could be said to delegate some decision-making authority to the agent. This relationship creates much uncertainty because of various information asymmetries (Deegan & Unerman, 2011). When both parts will act to maximize their own utility, there is no reason to believe that the agent always will act with the principal’s best in mind (Godfrey et al., 2000). There will be a conflict in interest, which is assumed to be brought into equilibrium either by contracts or by investing in information systems such as budgeting systems or reporting procedures (Eisenhardt, 1989). The theory focuses on determining the most efficient contract governing the principal-agent relationship given assumptions about people, organizations and information.

Adverse selection and moral hazard are two information-based problems that can explain the divergence between self-interest and cooperative behavior (Riahi-Belkaoui, 2004). Adverse selection occurs when the principal cannot verify the private information the agent uses and thereby making the principal incapable of determining the accuracy of the agent’s choice. Moral-hazard problems arise because of motivational problems and conflicts, which result from the contracts. It refers to lack of effort on the part of the agent and the agent is actually shirking (Eisenhardt, 1989). It is impossible to foresee the
behavior of the agent after the signing of contract. The heart of the principal-agent theory is the trade-off between the cost of measuring behavior and the cost of measuring outcomes and transferring risk to the agent. Information is here regarded as a commodity, that is; it has a cost and it can be purchased.

10.5.3 Designed accounting

Managements can easily choose suitable accounting techniques that are consistent with pre-established goals (Riahi-Belkaoui, 2004). By doing so the management affects the accounting with the aim to show their preferred picture of the entity. This is especially likely to incur when the accounting is based on principles. This phenomenon is often called designed accounting and includes different concepts such as income smoothing and “big bath” accounting. Income smoothing refers to shifting incomes so that earnings from peak years are reported in years with lower earnings. This makes the reported income less variable. Big bath accounting is about management drastically reducing earnings per share just to be able to increase the ration in the future. Generally this follows a management change giving the new managers an opportunity to be evaluated upon a lower income, which will give them an initial good performance.

10.6 Summary

How to report for goodwill in the financial reports has been debated for more than a century and several methods have been used. The standards regulating goodwill accounting today were introduced by IASB in 2004. This new regulation was aimed to improve information of acquired goodwill and removed the amortization method because it did not contain information value for the users of the financial reports. The new standards have although been criticized, entities have difficulties applying the regulation and the impairment test demands assessments which create opportunities for interpretations.

IFRS 3 and IAS 36 regulate goodwill accounting. Acquired goodwill is capitalized and tested for impairment annually. Studies have shown that the treatment of goodwill differs between entities due to different approaches in accounting, which complicates the comparability. The users should, according to the standards, receive information that enables an evaluation of the effect and nature of the acquisition. Although there is an “information overload” in accounting, it seems like entities currently do not leave enough disclosure.

The financial accounting has been explained by different kinds of images, such as the information process model. The conceptual framework states two fundamental characteristics for the information to be useful; relevance and faithful representation. According to the agency theory the relationship between the agent and the principal creates much uncertainty because of various information asymmetries. At last, the consequences of chosen accounting methods were explained, which can arise when managements strive to establish pre-established goals of their own.
10.7 Analysis and discussion

This section will discuss the previously mentioned empirical information and the theories to answer the questions posed in the introduction of the chapter. The analysis and discussion is divided into three parts: the core of goodwill, the information process and different methods.

10.7.1 The core of goodwill

According to IFRS 3, acquired goodwill is a residual post that cannot be estimated individually. The standard does not more closely mention what goodwill consists of. As mentioned in the empirical section goodwill can be seen as future extra profits. If this is true, it should be possible to estimate the value of goodwill separately as other assets are treated, without using the acquisition method. When entities are about to acquire a subsidiary, a proper analysis of the entities’ values is made with thorough investigation. It is common sense that entities will not pay more than necessary for the subsidiary. Because of this comprehensive procedure the acquirer should have enough knowledge to estimate the present value of making extra profits in the future. Drefeldt (2009) is despite this questioning the accuracy of the analysis and she believes that goodwill is a dream, not a true value, of making extra profits. If this were true, the goodwill would depend on the managements’ dreams and therefore, according to the agency theory, be affected by the personality of those people. Because business acquisitions contain large amounts it is not likely that it is only a dream, but maybe a part of it could be. This discussion seems to resemble gambling and involves large risk taking. Managements are willing to take these risks because they are often the agent playing with the principal’s money. The information asymmetry between the owner and the management gives clearance for the management to act more hazardous. Churyk and Cripe (2011) points out that managers can act in their own interest and pay a surplus in order to receive personal benefits. It is however quite obvious that all human beings are more or less selfish by nature. To minimize the costs of supervising the agent, the principal prefers to employ individuals with less self-interest and the entity’s best in mind. According to the theory about adverse selection it is although impossible in advance to know which individuals to choose taken this into account. It is difficult for the principal to predict behavior despite a thorough examination of a future employee.

Today it is only possible to capitalize goodwill acquired in a business combination. This acquired goodwill really contains the same future profits as the internally generated but they are treated in different ways. This is an inconsistent way of treating the same phenomenon. Just because an entity has paid for these so-called extra profits, it is acceptable to capitalize it. This could probably lead to incentives for entities to buy other entities just to be able to recognize an intangible asset.

At the acquisition date, the acquired goodwill is capitalized on the balance sheet. As time goes by, goodwill will decrease in value but if the entity works “extra hard” new internally generated goodwill will increase the value of the CGU, and there will not be a need for impairment losses. This results in internally generated goodwill being capitalized and mixed with the acquired goodwill. This is unfair in comparison with entities that are not a part of a business combination and complicates the comparability, which is one of the enhancing characteristics of the conceptual framework. A reduction
of the comparability decreases the information usefulness, which is a contrary to the aim of IASB.

There is a possibility that a gap exists between accounting business combinations and the procedure concerning the acquisition. People with different approaches, as well as skills, are involved in the acquisition process. The people purchasing a subsidiary may not have the accounting in mind, which makes it problematic for the accountants due to this reactive way of thinking.

The purpose of the new standard was to recognize smaller goodwill posts among business combinations. This purpose indicates that the goodwill post is not really desired. The fact that it is desirable to minimize goodwill makes us question the real core. Although, Malmqvist (2009) is very critical to this new approach and claims that even the expertise does not understand the allocation of the surplus value and therefore all of the purchased intangible assets should be goodwill. This illustrates another gap between regulation and practice.

10.7.2 The information process

The purpose of the new goodwill regulation was to improve the disclosure and thereby increase the usefulness for the receiver of the financial reports. Although Marton (2009), refers to a study made by two Scandinavian universities, which indicates that goodwill impairment provides less information after the introduction of IFRS than before, and it became less meaningful for shareholders to make use of the information.

The channel in the information process model is the financial reports that the entity publishes. The accountant makes the judgments and prepares the financial statements and is thereby the sender in the process. The receiver is obviously the user of the reports, which can be a variety of groups; primarily investors. It is important that the accountant understands what kind of information the user wants, not only what the standards explicitly require. Maybe, it is not possible to satisfy all investors’ requirements if they differ. It is not guaranteed that the group of investors is homogeneous. According to the conceptual framework, the entity shall focus on the user when leaving information. The information should be useful and when choosing which information to disclose, the accountants have characteristics to follow in the conceptual framework. The most important are relevance and faithful representation.

Goodwill can be seen as future extra profit and the information concerning goodwill should be relevant because it has a predictive value. The study, referred to by Marton (2009), argues that the information although is not used and that implies this type of information is less relevant and not so important when making investment decisions. A problem is the predictability of potential impairment losses in the future. This information is uncertain and therefore less valuable for investors. According to Wines et al. (2007) there are errors in fair value estimation because several fair values exist. This would probably suggest that there is a lack of faithful representation since this characteristic demands a depiction free from error. The fact that entities apply different approaches although the standards regulating them are the same implies that the depiction is biased and therefore not neutral which a faithful representation requires. The conceptual framework does however allow minor flaws concerning the representation.

It is obvious that accountants cannot provide unlimited information, but the characteristics allow interpretations and it is therefore likely that entities will disclose different kind of information. If the information differs, the comparability is impeded.
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According to IFRS 3 the accountant shall leave a qualitative description concerning goodwill, but this is not more closely described in the standard. There is also a possibility to avoid this demand; if an entity has put reasonable effort it is not obligated to leave that kind of information. This makes it very easy to avoid leaving complicated disclosure, and depends upon the knowledge and conditions of the reporting entity. Because goodwill information is complex, it is likely to be an area left out. If an entity discloses too much information it can risk losing its competitive advantage. That is an adequate reason to disclose the minimum information required. The balance between the contradictions is difficult.

On the other hand, it is commonly discussed that there is an information overload in this area today. Reports like *Louder than words* points in that direction. This paper questions the relevance of corporate reports. According to the conceptual framework, relevant information shall be included. The definition of relevant is that the information influences the economic decisions. It is difficult for the accountant to know which information is relevant, leading to more information being disclosed. The more information the entity gives, the higher the probability is that it will be held accountable for the information disclosed. The financial statements are complex because of the length and level of detail and there is no reason not to believe that this is applicable to goodwill as well. This would be contradictory to the fact that the information is insufficient. One possible explanation to this is that the quality of the information is not sufficient. It is easier to leave information that is less complex. Goodwill is a complicated topic and perhaps this makes the accountants reluctant to give the disclosures.

According to Malmqvist (2009), it is hard for analysts to understand goodwill accounting treatment. The users of the financial reports are assumed to have some knowledge in economic and business activities, according to the characteristic understandability, found in the conceptual framework. A reasonable assumption to make is that financial analysts are even more educated than the average user. Our conclusion in this issue is that the “normal” user of the financial reports has serious implications in understanding the goodwill concept. It could depend on the information content but it could also depend on that the user does not try to understand it because he also has limited time/recourses. The user will probably spend his time/recourses on other things.

An important element in the information process model is feedback. In order for the sender to make changes to improve information he needs to know what the receiver really wants, and to know if the given information is desirable. It is an important evaluation to improve the financial reporting in the future. There is a risk that the criticism is unjustified and because of this less useful for the sender. Constructive criticism is necessary. The feedback is also a tool for the user to show his demand for disclosure.

As we stated earlier, IFRS 3 requires a qualitative description but if it is impracticable to implement it can be ignored. One reason for impracticability could be the cost associated with the producing of this type of information. To make the impairment testing it requires a lot of resources because it is time consuming. The benefits must exceed the costs in order to make it worth to produce the information. An entity has limited resources and the allocating management may not find goodwill accounting a priority because the goodwill does not generate any cash flow. Maybe the management has another perspective than the accountant. The cash flow is a central factor when estimating an entity’s value. The importance of future cash flows may indicate that goodwill accounting is not a critical issue when making an investment decision.
The users might know that design accounting affects the accounting in different ways, like income smoothing and big bath accounting. With this in mind, users, such as investors, might not find the information useful. We presume that investors have knowledge of the management’s strive to influence the accounting in a way they prefer. Accounting is based on subjective assessment and the regulations regarding goodwill give a wider range of possibilities because of the great flexibility of the standard. IFRS is principle based, which leaves more room for interpretation, but the requirement concerning goodwill opens up to flexibility. This flexibility could create suspicion among the users, which we believe can be reduced through more disclosure in the notes.

At last, a factor that needs to be considered is that the discussed standard is relatively new and allows a new way of thinking. It might take some time to develop a shared mindset between entities.

10.7.3 Different methods

Earlier in the US, the pooling method was frequently used to classify business combinations as mergers to avoid receiving a goodwill post. The possible reasons for this might be that goodwill is difficult to manage and that it contributes to expenditures, such as amortizations or impairment losses. The incorrect use of the pooling method did not comply with the principle of substance over form. The change was intended to increase the comparability among entities. Thus, this comparability is only useful regarding the initial recognition of a business combination.

Although there is only one acquisition method, it can be used in different ways, as Gauffin and Nilsson (2011) stated. This decreases the comparability because the size of the goodwill differs. Their explanation to this is the entity size. We also believe that the type of industry can affect the allocation. This may lead to that the comparability although is quite high, which is an aim in the conceptual framework.

The subsequent measurement according to IAS 36 has complicated comparability according to Petersen and Plenborg (2010), because of the subjective judgments. Although we believe that this could be resolved by leaving more disclosures, because that makes the subjective assessments objective.

In recent years the use of fair value has increased in many standards (Deegan & Unerman, 2011) and because of this the development of goodwill accounting is logical. We believe that this accounting treatment better reflects a faithful representation rather than historical cost accounting. A problem is when capital markets are imperfect or incomplete and the fair value concept is ambiguous with respect to measurement and valuation (Wines et al., 2007). Then, it is possible that several fair values exist with the consequence of error in fair value estimates, which affects the information relevance.

The previously used method of amortization of goodwill is up to debate (RFR, 2012). The Swedish Financial Reporting Board requests in their response to the questionnaire made by EFRAG, that all intangible assets should be treated in a similar way; goodwill should be amortized.

Petersen and Plenborg (2010) state that the great benefit of amortization is that it is easier to predict the effect on the earnings. We believe that this would be interesting for the investor, but Wines et al. (2007) have shown that there is no correlation between the share value and the amortization. We believe this contradiction could be explained by a heterogeneous group of investors who differ in risk aversion and preferences. There will always be groups of investors focusing on different parts of the accounting. The ones
who believe that the current goodwill standards are the most appropriate are probably those who think goodwill accounting plays an important role in accounting. The relatively new IFRS for SMEs requires goodwill to be amortized. This regulation simplifies the treatment of goodwill from the entities’ perspective, not the users. We wonder why these investors would demand a different treatment.

Compared to amortizations, the procedure of impairment creates larger fluctuations in earnings. An inconsistent area in the treatment of impairment is that it is not allowed to reverse impairment losses, as it is with other assets when the value has increased. This must although be in the interest of the users. We believe that the users are interested in rises as well as declines. This makes us question if the impairment test really reflects a faithful representation.

10.8 Conclusion

If goodwill is considered being extra profits in the future, it should be possible to make an estimate independently and not see it as a residual post, which is the standard setter’s point of view. The ambition to eliminate goodwill also gives signals that the post is not desirable. The core of goodwill is therefore dual; on one side a future benefit and on the other side an issue that is very difficult to handle in accounting due to its uncertainty and vapidity.

Besides the fact that the core of goodwill is disputed, the inconsistent treatment of acquired and internally generated goodwill makes the matter even more complex and raises among other things questions concerning the core. Because internally generated goodwill is not identifiable it cannot be capitalized. After a business combination has occurred, these two different types of goodwill get mixed and it is obvious that the boundary between them is blurred, which causes accounting difficulties through inconsistency.

Investors can through disclosures make their own decisions and qualitative assessments of the financial status of the entity. As long as the methods for measuring and recognizing are clearly described, the investor is not deceived. Through extensive disclosure the entity’s subjective judgments can be made objective in the eyes of the user.

An important matter to consider is the decision usefulness that involves information concerning goodwill accounting. How important is really the amount of and the treatment of goodwill to the investors? According to what we have seen, there is something that differs. While some demand more disclosure, others claim that goodwill is irrelevant because of the complexity. The big uncertainty surrounding this area could make the information less interesting when making an investment decision. Although the fact that goodwill in many cases is a large amount contradict this assumption; the bigger the amount is, the greater the influence in the financial reporting ought to be.

Currently an “information overload” prevails, where, among other things, the amount of and relevance of the information disclosed is debated. A purpose with the standard was to improve the information and the information usefulness. These two views could be contradictive. A reason could therefore be that the given information concerns the wrong issues and that other information is wanted.

In order to “send” the right information, the sender must be able to understand what the receiver would like to know. Feedback is a helpful tool to improve the information process. An aspect to consider is the heterogeneity of the investors. This group may find
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different information relevant and has varied preferences. The current debate shows this fact.

Each alternative treatment of goodwill is complicated in its own way. Current accounting alternative, based on the fair value view, were intended to better give a faithful representation than historical cost accounting. The downside is the flexibility in the measurement. The amortization method is easier, but does not reflect reality in the same way. The cost of producing the information has to be considered – present accounting requires far more time and effort, than the previous method. A flexible way of accounting also decreases the comparability. Impairment testing and impairment losses make the earnings more volatile and it is easier to predict the income when using amortization. Another question is if the impairment test really gives a more faithful representation. That could be the case if the entities act as the standard intended. Due to the fact that it is not allowed to reverse an impairment loss, the entities might be reluctant to make such a permanent action.

The method preferred might as well depend on the investor’s view of goodwill and the goodwill accounting; if the investor finds goodwill to be important and relevant he might prefer the accounting today, but if he considers goodwill to be an irrelevant area he might prefer the less expensive and easier amortization method.

The gap between the regulation and the practice contributes to our conclusion that there really is no uniform explanation to the core of goodwill. This reasoning might also explain the complexity of goodwill. The fact that it is desirable to minimize goodwill, as well as the wide complexity concerning the recognition and treatment of goodwill, leads us to the conclusion that there is need for a new regulation where the rules are stricter and give goodwill a definite useful life. In our opinion, goodwill only is a residual and it might be better to call it “lines of errors and omissions” to clarify for the users what it really is. This would also solve the problem concerning the disclosures. If the treatment is less complex the disclosure’s scope can be reduced and more uniform, which increases the comparability among entities.

10.9 Questions

- Why is goodwill a problematic area?
- Which methods can be used to recognize goodwill?
- Describe the information process model in an accounting context!
- What are the most fundamental characteristics in the conceptual framework and what do they imply?
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Internet