

Level : BS / PGD

Financial Reporting-III

Course Code: 5591



**Department of Commerce
Faculty of Social Sciences & Humanities
Allama Iqbal Open University, Islamabad**

FINANCIAL REPORTING III

Code 5591

**FOR BS ACCOUNTING &
FINANCE/PGD IN IFRS**



**DEPARTMENT OF COMMERCE
ALLAMA IQBAL OPEN UNIVERSITY ISLAMABAD**

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FOREWORD

It is with great pleasure that I present this comprehensive study guide of *Financial Reporting III* (Course Code 5591) developed for the BS Accounting & Finance and PGD in IFRS programs at Allama Iqbal Open University (AIOU). As Pakistan's leading institution in open and distance learning, AIOU has consistently aimed to provide high-quality education that meets global standards and addresses the evolving needs of the business and financial sectors.

In an era marked by dynamic economic environments and evolving international Standards, proficiency in financial reporting has become paramount for professional and students alike. This book comprehensively covers critical International Financial Reporting Standards (IFRS) that shape modern financial practices, including IFRS 1, IFRS 2, IFRS 5, IFRS 7, IFRS 8, IFRS 10, IFRS 12, IFRS 13, and IFRS 15. Each chapter is designed to provide detailed insights into the principles, applications, and implications of these standards, fostering a deeper understanding of complex financial concepts and their practical relevance.

AIOU remains committed to fostering academic excellence and professional competence. This book not only aligns with the curriculum requirements but also contributes to enhancing analytical skills and critical thinking among students, ensuring they are well-equipped to meet the challenges of the global financial landscape. The integration of real-world examples and test questions will further aid learners in applying theoretical knowledge to practical scenarios.

I extend my gratitude to the faculty members and experts whose dedication and scholarly contributions have enriched this academic resource. It is my hope that this book will serve as a valuable guide for students, educators, and professionals, enhancing their understanding of financial reporting and contributing to their academic and professional growth. We at AIOU continue to strive for excellence in education, committed to empowering learners with knowledge and skills that inspire success and innovation.

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TABLE OF CONTENTS

Unit No.	IFRS	Description	Page No.
1	IFRS 1	First-time Adoption of International Financial Reporting Standards	7
2	IFRS 2	Share-based Payment	19
3	IFRS 5	Non-current Assets held for Sale and Discontinued Operations	31
4	IFRS 7	Financial Instruments: Disclosures	41
5	IFRS 8	Operating Segments	51
6	IFRS 10	Consolidated Financial Statements	61
7	IFRS 12	Disclosure of Interests in Other Entities	73
8	IFRS 13	Fair Value Measurement	87
9	IFRS 15	Revenue from Contracts with Customers	99

COURSE INTRODUCTION

Financial reporting plays a vital role in ensuring transparency, accountability, and comparability in financial statements across businesses and industries. *Financial Reporting III* is designed to equip learners with an in-depth understanding of advanced International Financial Reporting Standards (IFRS) and their practical applications. This course provides a structured approach to analyzing financial statements, recognizing key disclosure requirements, and ensuring compliance with international accounting standards. Through the study of IFRS, students will gain insights into the complex financial reporting landscape, enabling them to make informed business and investment decisions. The course is particularly beneficial for professionals in accounting, finance, and auditing, as well as students pursuing careers in financial reporting and corporate governance.

The course comprises nine comprehensive units, each covering a critical aspect of IFRS. It begins with IFRS 1: First-time Adoption of IFRS, which guides entities transitioning to IFRS for the first time. This is followed by IFRS 2: Share-Based Payment, which explores the recognition and measurement of equity and cash-settled share-based transactions. The course then delves into IFRS 5: Non-Current Assets Held for Sale and Discontinued Operations, focusing on the classification, measurement, and presentation of assets and operations intended for disposal. Additionally, IFRS 7: Financial Instruments – Disclosures ensures that students understand the reporting requirements for financial assets and liabilities, helping organizations communicate risk exposures effectively.

As the course progresses, students will engage with IFRS 8: Operating Segments, which emphasizes segmental reporting and the management approach to financial disclosures. IFRS 10: Consolidated Financial Statements provides a framework for consolidating financial results across parent and subsidiary entities. IFRS 12: Disclosure of Interests in Other Entities further expands on the disclosure requirements for subsidiaries, associates, and joint ventures. To ensure a solid grasp of fair value accounting, IFRS 13: Fair Value Measurement is introduced, covering valuation techniques and the fair value hierarchy. The course concludes with IFRS 15: Revenue from Contracts with Customers, which standardizes revenue recognition principles across industries, ensuring clarity and consistency in financial statements.

By the end of this course, learners will have developed a strong foundation in financial reporting, enabling them to apply IFRS standards effectively in real-world scenarios. The course emphasizes practical applications through case studies, industry examples, and problem-solving exercises. With an increasing demand for global financial harmonization, mastering these IFRS standards will enhance career opportunities and professional competencies. Whether pursuing a role in corporate finance, auditing, or financial advisory, this course provides the essential knowledge and analytical skills required for success in the evolving field of financial reporting.

Moazzam Ali
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Unit: 1

First-Time Adoption of International Financial Reporting Standards

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Unit 1: IFRS 1

First-Time Adoption of International Financial Reporting Standards

Unit Introduction

IFRS 1, "First-Time Adoption of International Financial Reporting Standards," is a pivotal standard issued by the International Accounting Standards Board (IASB) to guide entities transitioning to IFRS. It ensures that the financial statements of first-time adopters are transparent, comparable, and reliable, serving as a foundation for future financial reporting. This standard addresses the challenges entities face when transitioning from national GAAP to IFRS, providing a framework for recognizing, measuring, and disclosing financial information. The journey toward IFRS 1 began with the establishment of the IASB in 2001, which replaced the International Accounting Standards Committee (IASC). IFRS 1 was initially issued in 2003 and has since been amended to address emerging challenges and simplify the transition process. The adoption of IFRS worldwide, now spanning over 140 jurisdictions, reflects its global importance in promoting transparency and comparability. By providing exemptions and mandatory exceptions, IFRS 1 balances the need for high-quality financial information with the practical challenges of transitioning to a new accounting framework. For instance, a Japanese company transitioning from local GAAP to IFRS to list on the New York Stock Exchange utilized IFRS 1 to prepare comparable financial statements for global investors. This standard ensures that all adjustments during the transition are systematically disclosed, enhancing investor confidence and facilitating cross-border investments. IFRS 1 remains critical in fostering consistent and high-quality financial reporting globally.

OBJECTIVES

By the end of this unit, learners should be able to:

- i. Explain the objectives and importance of IFRS 1 in the global financial reporting landscape.
- ii. Identify the scope of IFRS 1 and its application to first-time adopters.
- iii. Describe the recognition and measurement principles applied during the transition to IFRS.
- iv. Analyze the exemptions and exceptions provided by IFRS 1 and their practical application.
- v. Interpret the presentation and disclosure requirements under IFRS 1, including reconciliations and adjustments.

1.1 About IFRS 1:

- i. **Overview of IFRS 1:** IFRS 1, "First-time Adoption of International Financial Reporting Standards," is a comprehensive standard issued by the International Accounting Standards Board (IASB) to guide entities transitioning to IFRS for the first time. The standard is vital because it establishes the procedures that companies must follow when they adopt IFRS, ensuring that their financial statements are comparable, transparent, and provide a reliable foundation for future financial reporting.
- ii. **History and Development of IFRS 1:** The journey towards IFRS 1 began with the creation of the IASB in 2001, which replaced the International Accounting Standards Committee (IASC). The IASB's primary mission was to develop a single set of high-quality, understandable, and enforceable global accounting standards. The need for such standards was driven by the increasing globalization of business and capital markets, where differences in accounting practices created barriers to cross-border investment and capital flows.
- iii. Before the issuance of IFRS 1, companies followed various national Generally Accepted Accounting Principles (GAAP). This led to significant discrepancies in financial reporting, making it difficult for investors, analysts, and other stakeholders to compare financial statements across different jurisdictions. As a result, the IASB recognized the necessity of a standard that would help entities transition smoothly from their previous GAAP to IFRS.
- iv. **Initial Issuance and Amendments:** IFRS 1 was first issued in June 2003. The primary aim was to ensure that an entity's first IFRS financial statements contain high-quality information that is transparent, comparable, and provides a solid foundation for future financial statements. Since its initial release, IFRS 1 has undergone several amendments to address emerging issues and to simplify the transition process for entities adopting IFRS.
- v. For instance, in December 2010, the IASB made significant amendments to IFRS 1 to address concerns raised by stakeholders about the complexity of the standard. The amendments introduced additional exemptions and clarified existing ones, making it easier for first-time adopters to transition to IFRS.

- vi. **Global Adoption of IFRS:** The adoption of IFRS worldwide has been a significant milestone in achieving financial reporting transparency and comparability. Over 140 jurisdictions, including the European Union, Australia, Canada, and many countries in Asia and Africa, have adopted IFRS. The adoption of IFRS has facilitated cross-border investments and capital flows by reducing the barriers created by differing national accounting standards.
- vii. **Example:** Consider a scenario where a company in Japan, which historically followed Japanese GAAP, decided to list its shares on the New York Stock Exchange (NYSE). To meet the requirements of the NYSE, the company had to transition to IFRS. IFRS 1 provided the necessary framework to guide the company through this transition, ensuring that its first set of IFRS financial statements were prepared in a manner that was consistent with global standards. The adoption of IFRS allowed the company to present its financial performance in a way that was comparable to other companies listed on the NYSE, thereby enhancing its attractiveness to international investors.

1.2. Objectives of IFRS 1:

- i. **Primary Objective:** The primary objective of IFRS 1 is to ensure that an entity's first IFRS financial statements contain high-quality information that is transparent, comparable, and reliable. This objective is achieved by providing specific guidelines on how to recognize, measure, and disclose financial information during the transition to IFRS.
- ii. **Transparency and Comparability:** One of the key objectives of IFRS 1 is to enhance the transparency and comparability of financial statements. Transparency in financial reporting means that the financial statements provide clear and comprehensive information about an entity's financial position, performance, and cash flows. Comparability, on the other hand, allows users of financial statements to compare the financial information of different entities, regardless of their geographical location or industry.
- iii. **Reliable Financial Information:** Reliability is another critical objective of IFRS 1. Reliable financial information is accurate, free from material errors, and faithfully represents the economic reality of the entity's financial activities. By ensuring that first-time adopters of IFRS provide reliable

information, IFRS 1 contributes to the overall credibility of the financial reporting process.

- iv. **Facilitating Consistent Application of IFRS:** IFRS 1 aims to promote the consistent application of IFRS across all entities, regardless of their previous accounting framework. This is crucial because consistency in financial reporting ensures that financial statements are prepared in accordance with the same principles and standards, allowing for meaningful comparisons between entities.
- v. **Reducing the Cost of Transition:** While transitioning to IFRS can be a complex and costly process, IFRS 1 includes provisions to help reduce the financial burden on entities. For example, the standard offers several exemptions that allow entities to avoid the potentially onerous task of restating certain past transactions in accordance with IFRS. These exemptions are designed to strike a balance between the need for high-quality financial information and the practical challenges of transitioning to a new accounting framework.
- vi. **Example:** Consider a company in Pakistan that is transitioning from Indian GAAP to IFRS. The company's previous financial statements may have been prepared using different recognition and measurement criteria than those required by IFRS. IFRS 1 guides the company through the transition process, ensuring that its first IFRS financial statements are transparent, comparable, and reliable. By adopting IFRS, the company can provide financial information that is more comparable to its global peers, thereby attracting potential investors and facilitating access to international capital markets.

1.3. Scope of IFRS 1

- i. **Entities Subject to IFRS 1:** IFRS 1 applies to entities that are adopting IFRS for the first time as their basis for preparing general-purpose financial statements. This standard is relevant to entities transitioning from any previous GAAP to IFRS, regardless of their size, industry, or geographic location.
- ii. **First-Time Adopters:** A first-time adopter is defined as an entity that, for the first time, makes an explicit and unreserved statement of compliance with IFRS in its financial statements. This could be an entity that previously

followed a national GAAP or one that did not prepare any financial statements under a recognized framework.

- iii. **General-Purpose Financial Statements:** IFRS 1 applies to entities preparing general-purpose financial statements. These are financial statements intended to meet the needs of a wide range of users, including investors, creditors, regulators, and other stakeholders. General-purpose financial statements are typically prepared on an annual basis and include a statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows, and accompanying notes.
- iv. **Transition Date:** The date of transition to IFRS is a critical concept in IFRS 1. It refers to the beginning of the earliest period for which an entity presents full comparative information under IFRS in its first IFRS financial statements. The transition date sets the stage for the application of IFRS to all relevant financial information, including the recognition, measurement, and disclosure of assets, liabilities, income, and expenses.
- v. **Scope of Exemptions and Exceptions:** IFRS 1 provides a range of exemptions and exceptions that are available to first-time adopters. These exemptions and exceptions are designed to simplify the transition process and reduce the burden on entities. However, the scope of these exemptions and exceptions is carefully defined to ensure that the integrity of the financial reporting process is maintained.
- vi. **Practical Example:** Consider a scenario where a mid-sized manufacturing company in Brazil is preparing to adopt IFRS for the first time. The company has previously prepared its financial statements under Brazilian GAAP, which has some significant differences from IFRS, particularly in areas such as revenue recognition and asset valuation. As a first-time adopter, the company must apply IFRS 1 to its financial statements, ensuring that all relevant information is recognized, measured, and disclosed in accordance with IFRS.

1. 4. Recognition and Measurement under IFRS 1:

- i. **Principles of Recognition and Measurement:** IFRS 1 outlines specific principles for recognizing and measuring assets, liabilities, income, and expenses during the transition to IFRS. The standard requires entities to recognize all assets and liabilities that meet the recognition criteria under

- IFRS, derecognize items that do not qualify for recognition, and measure all recognized items in accordance with IFRS.
- ii. **Opening IFRS Statement of Financial Position:** At the date of transition, an entity is required to prepare an opening IFRS statement of financial position. This statement serves as the starting point for all subsequent financial reporting under IFRS. In the opening statement of financial position, all assets and liabilities must be recognized and measured in accordance with IFRS, with adjustments being made to retained earnings or another component of equity as necessary.
 - iii. **Recognition and Derecognition:**
 - a. **Recognition:** Entities must recognize all assets and liabilities that meet the recognition criteria under IFRS. For example, if a company previously did not recognize certain intangible assets under its previous GAAP, but those assets meet the recognition criteria under IFRS, they must be recognized in the opening IFRS statement of financial position.
 - b. **Derecognition:** Conversely, entities must derecognize items that do not qualify as assets or liabilities under IFRS. For instance, if a company previously recognized a liability for provisions that do not meet the recognition criteria under IFRS, that liability must be derecognized.
 - iv. **Measurement:**
 - a. **Measurement of Assets and Liabilities:** All recognized assets and liabilities must be measured in accordance with IFRS. This includes the use of fair value measurements, amortized cost, or other appropriate measurement bases as specified by the relevant IFRS standards.
 - b. **Fair Value as Deemed Cost:** IFRS 1 provides an exemption that allows entities to use fair value as the deemed cost for certain assets, such as property, plant, and equipment, at the date of transition. This can simplify the transition process by avoiding the need to retrospectively determine the cost of these assets under IFRS.
 - v. **Adjustments to Equity:** All adjustments made during the transition to IFRS must be recognized directly in retained earnings or another category of equity at the date of transition. These adjustments may arise from the recognition or derecognition of assets and liabilities, changes in measurement bases, or the application of IFRS-specific requirements.

vi. Exemptions to Ease Transition: IFRS 1 provides a range of exemptions that allow entities to avoid the potentially burdensome task of restating certain past transactions in accordance with IFRS. These exemptions include:

- a. **Business Combinations:** Entities may elect not to restate business combinations that occurred before the date of transition to IFRS. This exemption allows entities to avoid the complex task of re-evaluating past business combinations in accordance with IFRS 3, "Business Combinations."
- b. **Fair Value as Deemed Cost:** As mentioned earlier, entities may elect to use fair value as the deemed cost for certain assets at the date of transition.
- c. **Cumulative Translation Differences:** Entities may elect to reset cumulative translation differences for foreign operations to zero at the date of transition, simplifying the accounting for foreign currency translation adjustments.

Practical Example: A Practical Example of the application of IFRS 1's recognition and measurement principles can be seen in the case of a large European bank that transitioned from local GAAP to IFRS. The bank's previous GAAP allowed for the deferral of certain loan origination costs, but under IFRS, these costs had to be expensed as incurred. As a result, the bank was required to adjust its opening IFRS statement of financial position by derecognizing the deferred costs and reducing its retained earnings accordingly.

1.5. Presentation and Disclosure under IFRS 1

- i. **Importance of Presentation and Disclosure:** The presentation and disclosure requirements of IFRS 1 are critical to ensuring that users of financial statements understand the impact of the transition to IFRS on the entity's financial position, performance, and cash flows. These requirements are designed to provide transparency and clarity, enabling users to make informed decisions based on the financial information presented.
- ii. **Reconciliations:** One of the key disclosure requirements under IFRS 1 is the provision of reconciliations of equity and total comprehensive income from the previous GAAP to IFRS. These reconciliations help users understand the differences between the financial information presented under the previous GAAP and IFRS.
- iii. **Reconciliation of Equity:** Entities must provide a reconciliation of equity at the date of transition and at the end of the latest period presented in the

entity's most recent annual financial statements under the previous GAAP. This reconciliation should explain the adjustments made to equity as a result of the transition to IFRS.

- iv. **Reconciliation of Total Comprehensive Income:** Entities must also provide a reconciliation of total comprehensive income for the latest period presented in the entity's most recent annual financial statements under the previous GAAP. This reconciliation should explain the adjustments made to income and other comprehensive income as a result of the transition to IFRS.
- v. **Explanation of Adjustments:** Entities are required to provide an explanation of the material adjustments made during the transition to IFRS. This explanation should include a description of the significant differences between the previous GAAP and IFRS, the reasons for the adjustments, and the impact of the adjustments on the entity's financial position and performance.
- vi. **Disclosure of Voluntary Exemptions and Mandatory Exceptions:** IFRS 1 requires entities to disclose any voluntary exemptions or mandatory exceptions applied during the transition process. This disclosure is important because it provides users with insight into the entity's transition strategy and the choices made by management to facilitate the adoption of IFRS.
- vii. **Practical Example:** A Practical Example of the presentation and disclosure requirements under IFRS 1 can be seen in the case of a Canadian mining company that transitioned from Canadian GAAP to IFRS. The company provided detailed reconciliations of its equity and total comprehensive income, highlighting the adjustments made for differences in the recognition and measurement of exploration and evaluation assets. The company also disclosed the voluntary exemptions it applied, including the election to use fair value as deemed cost for certain mining properties. This disclosure provided investors and analysts with a clear understanding of the impact of the transition to IFRS on the company's financial statements.

1.6 Conclusion:

In conclusion, IFRS 1 is a critical standard that provides the necessary guidance for entities transitioning to IFRS for the first time. The standard ensures that an entity's first IFRS financial statements are transparent, comparable, and reliable, thereby enhancing the credibility of financial reporting on a global scale. The provisions of IFRS 1, including the recognition and measurement principles, exemptions, and presentation and disclosure requirements, are designed to facilitate a smooth transition to IFRS while maintaining the integrity of financial information. The global adoption of IFRS, supported by IFRS 1, has played a significant role in promoting financial transparency and comparability across borders, benefiting investors, regulators, and other stakeholders. The Practical Examples provided throughout this document illustrate how entities have successfully navigated the transition to IFRS, demonstrating the practical application of IFRS 1 in a variety of contexts. As the adoption of IFRS continues to grow worldwide, IFRS 1 will remain an essential tool for entities seeking to align their financial reporting with international standards, ensuring that they meet the expectations of global capital markets and other stakeholders.

Unit Summary

IFRS 1 establishes principles for transitioning to IFRS, ensuring that first-time adopters' financial statements are transparent, comparable, and reliable. It applies to entities transitioning from national GAAP to IFRS, providing specific recognition, measurement, and disclosure guidelines. The standard allows optional exemptions and mandatory exceptions to ease the transition process, ensuring practicality while maintaining the integrity of financial information. Key features include the preparation of an opening IFRS statement of financial position and reconciliations of equity and total comprehensive income from the previous GAAP to IFRS. Real-world examples, such as a Canadian mining company's disclosure of adjustments for exploration assets, highlight the standard's practical application. IFRS 1's provisions foster consistency and credibility in financial reporting, enabling entities to align with international standards and meet the expectations of global stakeholders.

Test Questions:

- i. What is the primary objective of IFRS 1?
- ii. Who is considered a first-time adopter under IFRS 1?
- iii. Why was IFRS 1 introduced by the IASB in 2003?
- iv. Explain the concept of the "date of transition" in IFRS 1.
- v. What is the purpose of the opening IFRS statement of financial position?
- vi. How does IFRS 1 ensure transparency and comparability in financial statements?
- vii. Describe one mandatory exception to the retrospective application of IFRS.
- viii. What is the significance of the fair value as deemed cost exemption?
- ix. How does IFRS 1 require entities to disclose reconciliations during the transition?
- x. Provide an example of a real-life scenario where IFRS 1 facilitated a company's transition to IFRS.

Unit: 2

Share Based Payments

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Unit 2: IFRS 2

Share-Based Payment

Unit Introduction

IFRS 2, "Share-Based Payment," issued by the IASB in February 2004, establishes principles for recognizing and measuring share-based payment transactions in financial statements. It applies to transactions where entities receive goods or services in exchange for equity instruments (such as shares) or cash payments based on the entity's equity value. The standard ensures entities recognize the cost of share-based payments, enhancing the transparency and comparability of financial statements. Before IFRS 2, many companies did not record share-based payments as expenses, leading to inflated profits. By mandating recognition, IFRS 2 presents a more accurate picture of an entity's financial performance. It applies to all types of share-based payments, including equity-settled, cash-settled, and those with a choice of settlement, while addressing modifications, cancellations, and group entity arrangements. For example, companies like Alphabet Inc. (Google) recognize stock options granted to employees as expenses over the vesting period. This ensures stakeholders understand the true cost of such payments. IFRS 2 has played a pivotal role in enhancing investor confidence by ensuring companies disclose the financial impact of share-based payment arrangements.

OBJECTIVES:

By the end of this unit, learners should be able to:

- i. Explain the purpose and importance of IFRS 2 in financial reporting.
- ii. Identify the types of share-based payment transactions covered under IFRS 2.
- iii. Describe the recognition and measurement requirements for equity-settled and cash-settled share-based payments.
- iv. Analyze the treatment of share-based payments with net settlement features or cash alternatives.
- v. Interpret disclosure requirements and the financial impact of share-based payment transactions on financial statements.

2.1. Objective of IFRS 2:

- i. **Primary Objective:** IFRS 2 "Share-based Payment" was issued by the International Accounting Standards Board (IASB) in February 2004. The primary objective of IFRS 2 is to establish the principles for recognizing and measuring share-based payment transactions in financial statements. This includes transactions where an entity receives goods or services in exchange for equity instruments (such as shares) or cash payments based on the value of the entity's equity instruments.
- ii. **Importance of Transparent Financial Reporting:** IFRS 2 aims to improve the transparency and comparability of financial statements by ensuring that entities recognize the cost of share-based payments. Prior to the introduction of IFRS 2, many companies did not recognize share-based payments as an expense, leading to an understatement of expenses and overstatement of profits. By requiring entities to recognize share-based payments, IFRS 2 provides a more accurate representation of the cost of remunerating employees and other parties.
- iii. **Enhancing Investor Confidence:** The recognition of share-based payments in financial statements also enhances investor confidence by providing a clearer picture of the entity's financial performance and position. Investors can better understand the impact of share-based payment arrangements on an entity's earnings and evaluate the true cost of compensating employees and other stakeholders.
- iv. **Practical Example:** Consider a technology company like Google (Alphabet Inc.), which offers stock options to its employees as part of their compensation package. Before the adoption of IFRS 2, the company might not have recognized these stock options as an expense, resulting in higher reported profits. However, under IFRS 2, Google must recognize the fair value of these stock options as an expense over the vesting period, providing a more accurate reflection of the company's financial performance.

2.2 Scope of IFRS 2:

- i. **Scope and Applicability:** IFRS 2 applies to all share-based payment transactions, including those where an entity acquires goods or services in exchange for:
 - a. Equity instruments of the entity (equity-settled share-based payment transactions).

- b. Cash or other assets where the amount is based on the price or value of the entity's equity instruments (cash-settled share-based payment transactions).
 - c. Share-based payment transactions with a choice of settlement (either in cash or equity).
- ii. **Exclusions from Scope:** However, IFRS 2 does not apply to transactions with shareholders acting in their capacity as shareholders, nor does it apply to transactions where the entity acquires goods that are part of a business combination.
- iii. **Complex Arrangements and Modifications:** IFRS 2 also addresses complex share-based payment arrangements, including modifications to existing agreements, cancellations, and settlements. The standard provides guidance on how to account for changes in the terms and conditions of share-based payment transactions, ensuring consistent application across different entities and scenarios.
- iv. **Practical Example:** A Practical Example of the scope of IFRS 2 can be seen in the case of multinational corporations like Amazon. Amazon might engage in various share-based payment transactions, including offering stock options to employees, restricted stock units (RSUs), and performance-based awards. These transactions are covered by IFRS 2, requiring Amazon to recognize the fair value of these awards as an expense in its financial statements.

2.3. Recognition under IFRS 2

- i. **Recognition Criteria:** Under IFRS 2, an entity must recognize the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. If the goods or services received do not qualify for recognition as assets, they should be recognized as an expense. For equity-settled share-based payment transactions, the entity must recognize an increase in equity. For cash-settled share-based payment transactions, the entity must recognize a liability.
- ii. **Measurement of Share-based Payments:** The standard requires the fair value of the equity instruments granted to be measured at the grant date. For transactions with employees and others providing similar services, the fair value is generally based on the market price of the equity instruments at the

grant date, adjusted for the terms and conditions upon which the instruments were granted.

- iii. **Fair Value Measurement:** Fair value measurement is a critical aspect of IFRS 2. Entities must use an appropriate valuation model, such as the Black-Scholes model or a binomial model, to determine the fair value of share-based payments. These models take into account various factors, including the expected volatility of the entity's share price, the risk-free interest rate, and the expected life of the options.
- iv. **Practical Example:** A practical example of recognition under IFRS 2 is found in companies like Facebook (Meta Platforms, Inc.), which frequently grants stock options and RSUs to its employees. Upon granting these equity instruments, Facebook must recognize the fair value of the awards as an expense over the vesting period. For instance, if Facebook grants stock options that vest over four years, the company would recognize the expense related to these options over that period, reflecting the cost of compensating its employees through share-based payments.

2.4. Equity-Settled Share-Based Payment Transactions:

- i. **Recognition and Measurement:** In equity-settled share-based payment transactions, the entity receives goods or services as consideration for its own equity instruments. The fair value of the goods or services received is recognized as an expense, with a corresponding increase in equity.
- ii. **Grant Date Fair Value:** The fair value of the equity instruments granted is measured at the grant date. For employee share-based payment transactions, the grant date is typically the date when the entity and the employee have a shared understanding of the terms and conditions of the arrangement.
- iii. **Vesting Conditions:** Vesting conditions, such as service conditions or performance conditions, must be considered when determining the fair value of the equity instruments. If the equity instruments do not vest, the expense is not recognized, and no equity is recorded.
- iv. **Modifications and Cancellations:** If an entity modifies the terms and conditions of an equity-settled share-based payment transaction, it must recognize any additional expense resulting from the modification. If the modification increases the fair value of the equity instruments, the additional expense is recognized over the remaining vesting period. If an equity-settled share-based payment is cancelled, the entity must recognize

the amount that would have been recognized over the remaining vesting period immediately.

- v. **Practical Example:** A Practical Example of equity-settled share-based payment transactions can be seen in companies like Apple Inc., which grants stock options and RSUs to its employees. When Apple grants these awards, it must recognize the fair value of the equity instruments as an expense over the vesting period. If Apple were to modify the terms of the awards, such as accelerating the vesting period or increasing the number of shares granted, it would need to account for the impact of these modifications in its financial statements.

2.5. Cash-Settled Share-Based Payment Transactions

- i. **Recognition and Measurement:** In cash-settled share-based payment transactions, the entity acquires goods or services by incurring liabilities to the supplier of those goods or services based on the value of the entity's equity instruments. The liability is measured at fair value and is remeasured at each reporting date until the liability is settled.
- ii. **Fair Value of Liability:** The fair value of the liability is determined based on the market price of the entity's equity instruments, adjusted for any terms and conditions that are specific to the share-based payment arrangement. Changes in the fair value of the liability are recognized in profit or loss for the period.
- iii. **Vesting and Non-Vesting Conditions:** For cash-settled share-based payment transactions, both vesting and non-vesting conditions must be considered. Vesting conditions determine whether or not the employee is entitled to receive the payment, while non-vesting conditions must be reflected in the fair value of the liability.
- iv. **Practical Example:** A Practical Example of cash-settled share-based payment transactions can be found in companies like Vodafone Group. Vodafone may offer cash-settled share appreciation rights (SARs) to its employees, which provide them with the right to receive cash payments based on the increase in the company's share price. Vodafone would recognize a liability for these SARs, which would be remeasured at fair value at each reporting date, with changes in the liability being recognized in profit or loss.

2.6. Share-Based Payment Transactions with a Net Settlement Feature for Withholding Tax Obligations:

- i. **Overview:** Some share-based payment arrangements include a net settlement feature to meet withholding tax obligations. In such arrangements, the entity issues equity instruments to the employee, and the employee is required to return a portion of those equity instruments to the entity to cover the tax obligation.
- ii. **Recognition and Measurement:** Under IFRS 2, when an entity settles a share-based payment arrangement net of withholding tax obligations, it must account for the entire arrangement as an equity-settled share-based payment. The portion of the equity instruments withheld for tax purposes is treated as a cash-settled share-based payment, and the entity recognizes a liability for the tax obligation.
- iii. **Practical Example:** A Practical Example of share-based payment transactions with a net settlement feature for withholding tax obligations can be seen in companies like Microsoft Corporation. Microsoft may grant RSUs to its employees, with a portion of the shares being withheld to cover the employees' tax obligations. Microsoft would account for the full value of the RSUs as an equity-settled share-based payment, while also recognizing a liability for the tax portion that is settled in cash.

2.7. Share-Based Payment Transactions with Cash Alternatives

- i. **Overview:** In some share-based payment arrangements, either the entity or the counterparty (usually the employee) has the choice of settling the transaction in cash or by issuing equity instruments. IFRS 2 provides guidance on how to account for such transactions, depending on who has the choice and the nature of the settlement alternatives.
- ii. **Accounting Treatment: Entity's Choice:**
 - a. If the entity has the choice of settling the transaction either in cash or by issuing equity instruments, the transaction is treated as a compound financial instrument. This means that it has both a liability component (the obligation to pay cash) and an equity component (the option to issue equity instruments).
 - b. The entity must first measure the liability component at fair value and recognize it as a liability. The equity component is then measured as the residual amount of the fair value of the total share-

based payment transaction less the fair value of the liability component.

- iii. **Counterparty's Choice:** If the counterparty has the choice of settling the transaction in cash or by receiving equity instruments, the entity must recognize a liability for the fair value of the amount payable in cash. If the counterparty chooses to receive equity instruments, the liability is reclassified to equity at the settlement date.
- iv. **Measurement of Fair Value:**
The fair value of the share-based payment with cash alternatives is determined at the grant date and is subsequently remeasured at each reporting date if a liability is recognized. The final fair value is determined at the settlement date.
- v. **Practical Example:** A practical example of share-based payment transactions with cash alternatives can be seen in companies like Goldman Sachs. Goldman Sachs may offer its employees a choice between receiving cash bonuses or equity-based awards (such as stock options). If the employees choose the cash option, Goldman Sachs recognizes a liability for the cash amount. If they choose the equity option, the liability is reclassified to equity, and the employees receive shares instead of cash.

2.8. Share-Based Payment Transactions Among Group Entities (2009 Amendments):

- i. **Background of 2009 Amendments:** In June 2009, the IASB issued amendments to IFRS 2 to provide clarity on the accounting for share-based payment transactions among group entities. These amendments addressed the complexity and diversity in practice regarding how to account for share-based payments involving multiple entities within a group.
- ii. **Key Changes Introduced by the Amendments:** The amendments clarified that in a group situation, the entity that receives the goods or services should recognize the share-based payment transaction, even if another group entity settles the transaction. The entity receiving the goods or services should recognize an expense and a corresponding increase in equity if the transaction is equity-settled, or a liability if it is cash-settled. If the entity settling the share-based payment transaction does not receive the goods or services directly, it should recognize an increase in equity as a contribution from the other group entity.

- iii. **Group-wide Equity and Cash Settled Payments:** The amendments also addressed situations where a parent company grants share-based payments to the employees of its subsidiary. The subsidiary, in this case, recognizes the expense over the vesting period with a corresponding increase in equity, while the parent company recognizes a contribution to equity.
- iv. **Practical Example:** A Practical Example of share-based payment transactions among group entities can be seen in multinational corporations like Unilever. Suppose Unilever's parent company grants stock options to employees of its subsidiary in a different country. The subsidiary would recognize the share-based payment expense in its own financial statements, with a corresponding increase in equity. The parent company would record the contribution as an increase in equity on its own financial statements, reflecting the group's overall transaction.

2.9. Disclosures under IFRS 2:

Importance of Disclosures: Disclosures are a critical aspect of IFRS 2 as they provide users of financial statements with the information necessary to understand the nature and impact of share-based payment arrangements on the entity's financial performance and position. Transparent and comprehensive disclosures enhance the comparability and reliability of financial statements.: Entities must provide detailed disclosures about the following aspects of their share-based payment transactions:

- i. **Nature and Scope of Arrangements:** Entities should describe the nature and scope of their share-based payment arrangements, including the types of awards granted (e.g., stock options, RSUs), the number of equity instruments involved, and the terms and conditions of the arrangements.
- ii. **Fair Value Determination:** Entities must disclose how the fair value of the share-based payments was determined, including the valuation models used (e.g., Black-Scholes, binomial model) and the key assumptions applied (e.g., expected volatility, risk-free interest rate, expected dividend yield).
- iii. **Expense Recognized:** The total expense recognized for share-based payment transactions during the reporting period must be disclosed, broken down by the type of payment (equity-settled, cash-settled, and those with cash alternatives).
- iv. **Outstanding Share-Based Payments:** Entities should disclose the number of share-based payments that are outstanding at the end of the reporting

period, along with their weighted average exercise prices, remaining contractual lives, and the number of shares that have vested.

- v. **Modifications and Cancellations:** If there have been any modifications or cancellations of share-based payment arrangements during the reporting period, entities must disclose the impact of these changes on the financial statements.

2.10 Conclusion:

IFRS 2 "Share-based Payment" plays a crucial role in ensuring that entities recognize and measure share-based payment transactions accurately in their financial statements. By requiring the recognition of share-based payments as expenses, IFRS 2 provides a more accurate reflection of the cost of compensating employees and other stakeholders, leading to greater transparency and comparability in financial reporting. The standard's comprehensive scope covers various types of share-based payment transactions, including equity-settled, cash-settled, and those with cash alternatives. The amendments to IFRS 2 have further clarified the accounting for complex transactions, such as those involving multiple group entities, ensuring consistent application across different entities and jurisdictions. The requirement for detailed disclosures under IFRS 2 enhances the transparency of financial statements, providing users with valuable insights into the nature and impact of share-based payment arrangements. These disclosures help investors, analysts, and other stakeholders make informed decisions by understanding the financial implications of share-based payments on the entity's performance and position.

The Practical Examples provided throughout this document illustrate how companies across various industries apply IFRS 2 to account for their share-based payment transactions, demonstrating the practical application of the standard in diverse contexts. As share-based payment arrangements continue to evolve, IFRS 2 will remain a critical standard for ensuring that entities report these transactions accurately and transparently, maintaining the integrity of financial reporting in a globalized business environment.

Summary of the Unit:

IFRS 2 provides a comprehensive framework for recognizing and measuring share-based payment transactions, including equity-settled, cash-settled, and those with cash alternatives. The standard ensures that entities account for the fair value of

share-based payments, improving transparency and comparability. Recognition criteria and valuation models like Black-Scholes are integral to measuring fair value accurately. Key aspects include accounting for vesting conditions, modifications, and cancellations. It also covers group entity transactions, where expenses are recognized by the entity receiving goods or services, even if settled by another group entity. Detailed disclosure requirements enhance understanding of share-based payment arrangements. Practical Examples, such as Vodafone's treatment of share appreciation rights and Tesla's disclosures on stock options, illustrate IFRS 2's practical application. By mandating these principles, IFRS 2 ensures entities provide accurate and reliable financial information about the impact of share-based payment transactions.

Test Questions:

- i. What is the primary objective of IFRS 2?
- ii. List the types of share-based payment transactions covered under IFRS 2.
- iii. Why was IFRS 2 introduced, and how does it improve financial reporting?
- iv. What valuation models are commonly used to measure the fair value of share-based payments?
- v. How does IFRS 2 define equity-settled share-based payment transactions?
- vi. What is the treatment of share-based payment transactions with net settlement features?
- vii. Explain how IFRS 2 addresses modifications to share-based payment arrangements.
- viii. How are cash-settled share-based payment transactions measured and recognized?
- ix. What disclosure requirements does IFRS 2 impose on entities?
- x. Provide a Practical Example of a company applying IFRS 2 to its share-based payment transactions.

Unit: 3

Non-Current Assets Held for Sale and Discontinued Operations

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UNIT 3: IFRS 5

Non-Current Assets Held for Sale and Discontinued Operations

Unit introduction:

IFRS 5, "Non-Current Assets Held for Sale and Discontinued Operations," is a critical standard issued by the IASB to provide guidelines for the recognition, measurement, presentation, and disclosure of assets and operations intended for sale or distribution. It ensures transparency by separating discontinued operations and non-current assets held for sale from continuing operations in financial statements, enhancing the quality of financial reporting. The standard has significant strategic implications, allowing entities to communicate their restructuring efforts, divestitures, and focus on core operations. It plays a vital role in helping investors and stakeholders assess the future direction of the entity and its ongoing financial performance. For example, companies like General Electric (GE) and Procter & Gamble (P&G) have applied IFRS 5 during major divestitures, presenting investors with a clearer understanding of their operational priorities and restructuring efforts. By requiring assets held for sale to be measured at the lower of carrying amount and fair value less costs to sell, IFRS 5 prevents overstated valuations. Similarly, discontinued operations are presented separately in the income statement, allowing stakeholders to focus on the financial impact of ongoing operations. This clear distinction provides a reliable foundation for decision-making and enhances comparability across industries.

OBJECTIVES:

By the end of this unit, learners should be able to:

- i. Explain the purpose and strategic importance of IFRS 5 in financial reporting.
- ii. Identify the recognition criteria for classifying non-current assets or disposal groups as held for sale or discontinued operations.
- iii. Describe the measurement principles applied to assets held for sale, including impairment considerations.
- iv. Analyze the presentation and disclosure requirements for non-current assets and discontinued operations.
- v. Apply IFRS 5 to real-life scenarios, including divestitures and discontinued operations, using financial data.

3.1. Objective of IFRS 5:

- i. **Strategic Importance of IFRS 5:** The objective of IFRS 5 goes beyond just the accounting treatment of non-current assets held for sale and discontinued operations; it also plays a strategic role in how companies communicate their restructuring, divestitures, and operational focus to investors and stakeholders. By requiring companies to separately present these items, IFRS 5 provides clarity on the ongoing business and the future direction of the entity, enabling stakeholders to make better-informed decisions.
- ii. **Enhancing Decision-Making:** For companies, classifying non-current assets as held for sale or presenting discontinued operations allows them to demonstrate their commitment to streamlining operations, focusing on core competencies, and improving financial performance. For investors and analysts, this separate presentation helps in assessing the quality of earnings, understanding the entity's strategic shifts, and evaluating the impact of asset sales or discontinued operations on the entity's future cash flows.
- iii. **Practical Example - Strategic Shift at General Electric (GE):** General Electric (GE), a global conglomerate, underwent a significant restructuring strategy starting in the mid-2010s, where it decided to exit non-core businesses and focus on its industrial operations. One of the most notable divestitures was GE's sale of its GE Capital unit. The assets and liabilities of GE Capital were classified as held for sale under IFRS 5, allowing investors to understand the impact of this major divestiture on GE's financial statements.
For instance, assume GE Capital had assets with a carrying amount of \$10 billion. GE determined that the fair value less costs to sell these assets was \$9 billion. GE would recognize an impairment loss of \$1 billion. This loss would be reflected in GE's income statement, providing a clear picture of the financial impact of the sale. The classification of GE Capital's assets as held for sale also indicated to investors that GE was committed to shedding non-core operations and focusing on its industrial business.

3.2. Scope of IFRS 5:

Detailed Analysis of Scope: IFRS 5's scope is broad, covering all non-current assets and disposal groups classified as held for sale, but with specific exclusions.

Understanding the scope of IFRS 5 is crucial for accurate application, as misclassification can lead to misstatement of financial results and misleading information to stakeholders.

Exclusions Explained:

- i. **Deferred Tax Assets:** Deferred tax assets are excluded because they are already accounted for under IAS 12 "Income Taxes," which provides specific guidance on their recognition and measurement.
- ii. **Employee Benefits:** Assets arising from employee benefits are governed by IAS 19 "Employee Benefits," which covers the recognition and measurement of defined benefit plans and other long-term employee benefits.
- iii. **Financial Instruments:** Financial assets and liabilities are excluded from IFRS 5's scope because they are covered by IFRS 9 "Financial Instruments," which provides comprehensive guidance on recognition, classification, measurement, and derecognition of financial assets and liabilities.

Practical Example - Scope Application at Procter & Gamble (P&G): Procter & Gamble (P&G), a multinational consumer goods company, decided in 2014 to divest its pet care business. The pet care division, including all related assets and liabilities, qualified as a disposal group under IFRS 5. However, the financial instruments (such as receivables and payables) associated with the pet care business continued to be accounted for under IFRS 9. The classification under IFRS 5 ensured that only the non-current assets and liabilities directly related to the pet care business were measured and presented according to the standard's requirements. For example, if the carrying amount of the pet care division's non-current assets was \$2 billion, and the fair value less costs to sell was determined to be \$1.8 billion, P&G would recognize a \$200 million impairment loss. The loss would be reported in the income statement, while the financial assets and liabilities associated with the pet care division would be presented separately under IFRS 9.

3.3. Recognition under IFRS 5:

In-Depth Recognition Criteria: The recognition criteria for classifying non-current assets (or disposal groups) as held for sale are stringent to ensure that only assets truly intended for sale are classified as such. This classification has significant implications, as it affects both the measurement and presentation of these assets in the financial statements.

- i. **Available for Immediate Sale:** This criterion ensures that the asset or disposal group is ready to be sold without significant delay, indicating the entity's firm intention to sell. The entity must have the ability and intention to execute the sale in its current state.
- ii. **Highly Probable Sale:** The sale must be highly probable, which requires management to have a committed plan to sell the asset. This includes having initiated an active program to locate a buyer, marketing the asset at a reasonable price, and expecting the sale to be completed within one year.

Practical Example: Ford Motor Company, one of the largest automotive manufacturers, decided to sell its manufacturing plant in Michigan. Assume the carrying amount of the plant was \$500 million. Ford classified the plant as held for sale under IFRS 5 after determining that the sale was highly probable, and the plant was available for immediate sale. Ford actively marketed the plant and received a fair value offer of \$450 million, with estimated costs to sell of \$10 million. The fair value less costs to sell was therefore \$440 million. This impairment was recognized in the income statement, and the plant was reclassified as an asset held for sale, ceasing further depreciation.

3.4. Classification of Non-Current Assets (or Disposal Groups) as Held for Sale or as Held or Distribution to Owners:

Detailed Classification Process: The classification of non-current assets or disposal groups as held for sale or held for distribution to owners is a critical step in applying IFRS 5. This classification determines how the asset or disposal group is measured and presented in the financial statements.

- i. **Held for Sale:**
 - a. The asset or disposal group must be available for immediate sale.
 - b. The sale must be highly probable, with a committed plan and active marketing efforts.
- ii. **Held for Distribution to Owners:**
 - a. Similar to held for sale, but instead of selling the asset or disposal group to a third party, the entity plans to distribute it to its shareholders.
 - b. The distribution must be highly probable, with the entity committed to the distribution plan and expecting it to be completed within one year.

Example: Unilever, a global consumer goods company, decided to spin off its tea business and distribute it to shareholders as part of a demerger. The tea business, which included various assets and liabilities, was classified as a disposal group held for distribution to owners. Assume the carrying amount of the tea business's assets was \$1 billion. After classification, Unilever determined that the fair value less costs to distribute was \$900 million. Consequently, Unilever recognized a \$100 million impairment loss. This loss was reported in the income statement, and the assets and liabilities of the tea business were reclassified as held for distribution to owners. Unilever ceased further depreciation of these assets, reflecting the company's commitment to the demerger and distribution to shareholders.

3.5. Measurement of Non-Current Assets (or Disposal Groups) Classified as Held for Sale

- i. **Measurement Methodology:** Once a non-current asset or disposal group is classified as held for sale, IFRS 5 requires it to be measured at the lower of its carrying amount and fair value less costs to sell. This measurement approach ensures that the asset is not overstated in the financial statements and reflects the entity's intention to recover its value through sale rather than continuing use.
- ii. **Fair Value Less Costs to Sell:** Fair value is determined based on market conditions, comparable sales, and discounted cash flow analysis, among other valuation methods. Costs to sell include direct costs such as legal fees, commissions, and closing costs that are necessary to complete the sale.
- iii. **No Further Depreciation:** After classification as held for sale, the asset or disposal group is no longer depreciated, as its value is expected to be recovered through sale. This cessation of depreciation is crucial because continuing to depreciate the asset could result in double-counting of expenses and an understatement of its value in the financial statements.
- iv. **Practical Example - British Petroleum (BP) Oil Rig Sale:** British Petroleum (BP), a multinational oil and gas company, decided to sell one of its oil rigs as part of its asset divestiture program. The carrying amount of the oil rig was \$800 million. BP classified the rig as held for sale under IFRS 5 and determined that the fair value less costs to sell was \$750 million, with estimated costs to sell of \$10 million. This impairment loss was reported in BP's income statement, and the oil rig was reclassified as an asset held for sale in the balance sheet. The rig was no longer depreciated,

reflecting BP's intention to sell the asset and recover its value through sale rather than continued use.

3.6. Presentation and Disclosure under IFRS 5:

IFRS 5 requires that non-current assets (or disposal groups) classified as held for sale be presented separately from other assets in the balance sheet. Similarly, liabilities of a disposal group classified as held for sale must be presented separately from other liabilities. Discontinued operations must also be presented separately in the income statement, with a clear distinction between continuing and discontinued operations. Entities must provide detailed disclosures about non-current assets (or disposal groups) classified as held for sale and discontinued operations. These disclosures include:

- i. **Description of the Non-Current Assets or Disposal Groups:** Entities must describe the nature of the assets or disposal groups, including their carrying amounts and the reasons for classification as held for sale or discontinued.
- ii. **Financial Impact:** Disclosures must include the results of discontinued operations, such as revenue, expenses, and profit or loss, as well as the net cash flows attributable to operating, investing, and financing activities of discontinued operations.
- iii. **Reconciliation to Financial Statements:** Entities should provide a reconciliation of the carrying amounts of major classes of assets and liabilities classified as held for sale.

Example: Coca-Cola decided to discontinue its juice production line as part of its strategy to focus on its core beverage products. The assets and liabilities related to the juice production line were classified as held for sale under IFRS 5. In the balance sheet, Coca-Cola presented the juice production line's assets and liabilities separately under the headings "Non-current assets held for sale" and "Liabilities directly associated with non-current assets held for sale." Assume the carrying amount of the juice production line's assets was \$600 million, and the fair value less costs to sell was \$550 million. Coca-Cola recognized a \$50 million impairment loss. The Coca-Cola also disclosed the expected sale price, the costs to sell, and the impact of the discontinuation on the company's overall strategy in the notes to the financial statements.

3.7 Conclusion:

- i. **Comprehensive Understanding of IFRS 5:** IFRS 5 "Non-current Assets Held for Sale and Discontinued Operations" provides a robust framework for the recognition, measurement, presentation, and disclosure of non-current assets intended for sale and discontinued operations. The standard ensures that these items are accurately reflected in the financial statements, providing stakeholders with relevant and reliable information for decision-making.
- ii. **Strategic Implications for Companies:** The classification and presentation of non-current assets as held for sale or discontinued operations can have significant strategic implications for companies. It signals to the market and investors the company's focus on its core operations, its divestiture strategy, and its plans for future growth. By separating these items from continuing operations, companies can provide a clearer picture of their financial performance and position.
- iii. **Real-Life Applications and Financial Impact:** The Practical Examples provided throughout this document illustrate how companies across various industries apply IFRS 5 to manage their non-current assets and discontinued operations. By incorporating financial data and detailed calculations, the examples highlight the practical application of the standard and its impact on the financial statements.
- iv. **Future Considerations:** As companies continue to evolve and adapt to changing market conditions, the application of IFRS 5 will remain critical in ensuring that non-current assets held for sale and discontinued operations are accurately reported. Companies must continue to refine their processes for classifying, measuring, and disclosing these items to meet the expectations of stakeholders and comply with international financial reporting standards.

Summary of the Unit:

IFRS 5 provides a framework for reporting non-current assets held for sale and discontinued operations, ensuring transparency and comparability. The standard requires these assets to be measured at the lower of carrying amount and fair value less costs to sell and mandates their separate presentation in financial statements. By ceasing depreciation on assets held for sale and requiring impairment losses to be recognized, IFRS 5 ensures accurate reporting. Classification criteria include the asset being available for immediate sale and the sale being highly probable. The standard also addresses assets held for distribution to owners. Detailed disclosure requirements help stakeholders assess the financial impact of discontinued operations and divestitures. Real-world examples, such as BP's oil rig sale and Coca-Cola's discontinued juice line, illustrate the practical application and strategic importance of IFRS 5.

Test Questions:

- i. What is the primary objective of IFRS 5?
- ii. What are the key recognition criteria for classifying an asset as held for sale under IFRS 5?
- iii. How is a non-current asset measured once classified as held for sale?
- iv. Why does IFRS 5 mandate ceasing depreciation for assets held for sale?
- v. What is the difference between assets held for sale and those held for distribution to owners?
- vi. Provide an example of an impairment loss calculation under IFRS 5.
- vii. How are discontinued operations presented in the income statement?
- viii. Why does IFRS 5 require separate presentation of non-current assets held for sale in the balance sheet?
- ix. What disclosures are required for discontinued operations under IFRS 5?
- x. Provide a Practical Example of a company applying IFRS 5 to a significant divestiture or restructuring effort.

Unit: 4

Financial Instruments – Disclosures

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UNIT 4: IFRS 7

Financial Instruments – Disclosures

Unit Introduction:

IFRS 7, "Financial Instruments – Disclosures," is a critical accounting standard issued by the IASB to enhance transparency in financial reporting. It requires entities to provide comprehensive disclosures about their financial instruments, helping users of financial statements evaluate their significance, risks, and financial impact. The standard applies to all recognized and unrecognized financial instruments, including assets, liabilities, and equity instruments. The primary objective of IFRS 7 is to ensure that investors and other stakeholders have a clear understanding of an entity's financial instruments, their classification, and associated risks. Financial institutions, such as banks, investment firms, and multinational corporations, heavily rely on IFRS 7 to disclose details about loans, derivatives, equity holdings, and other financial instruments. For example, JPMorgan Chase reports extensive details about its financial assets and liabilities, including classifications, fair value assessments, and risk exposures. These disclosures help stakeholders assess the company's financial health and decision-making processes. IFRS 7 plays a crucial role in financial reporting by fostering transparency, comparability, and risk assessment across different industries.

OBJECTIVES

By the end of this unit, learners should be able to:

1. Explain the scope and applicability of IFRS 7 in financial reporting.
2. Identify the different classes of financial instruments and the required level of disclosure.
3. Analyze how financial instruments impact an entity's financial position and performance.
4. Assess the nature and extent of risks arising from financial instruments and the required risk disclosures.
5. Interpret the disclosure requirements for transfers of financial assets and their implications for financial statements.

4.1. Scope of IFRS 7

Overview of Scope: IFRS 7 applies to all entities and covers the disclosure requirements for financial instruments. The standard requires entities to provide disclosures that enable users of financial statements to evaluate the significance of financial instruments for the entity's financial position and performance, as well as the nature and extent of risks arising from those financial instruments.

Financial Instruments Covered: IFRS 7 applies to all recognized and unrecognized financial instruments, including:

- i. Financial assets, such as cash, trade receivables, investments in debt and equity securities, and derivatives.
- ii. Financial liabilities, such as trade payables, loans, and derivatives.
- iii. Equity instruments issued by the entity, such as shares.

Exclusions: IFRS 7 does not apply to the following items:

- i. Interests in subsidiaries, associates, and joint ventures accounted for under IAS 27, IAS 28, and IFRS 11.
- ii. Employers' rights and obligations under employee benefit plans, which are accounted for under IAS 19 "Employee Benefits."
- iii. Insurance contracts accounted for under IFRS 4 "Insurance Contracts."

Practical Example: Consider JPMorgan Chase, one of the largest financial institutions in the world. The bank's financial statements include a wide range of financial instruments, from loans and receivables to complex derivatives. IFRS 7 requires JPMorgan Chase to disclose the nature and extent of these financial instruments, including their fair values, how they are classified, and the risks associated with them. For instance, JPMorgan Chase might have \$500 billion in loans and receivables, \$200 billion in available-for-sale financial assets, and \$300 billion in derivative financial instruments. IFRS 7 requires the bank to disclose detailed information about these instruments, including their classification, measurement, and the risks associated with them, such as credit risk, market risk, and liquidity risk.

4.2. Classes of Financial Instruments and Level of Disclosure:

Under IFRS 7, entities must disclose information by class of financial instrument. A class is a grouping of financial instruments that are similar in nature and function. The classification is typically based on the type of financial instrument, its purpose, and its measurement basis.

Common Classes of Financial Instruments:

- i. **Financial Assets at Amortized Cost:** This class includes financial assets such as loans, receivables, and held-to-maturity investments that are measured at amortized cost.
- ii. **Financial Assets at Fair Value through Profit or Loss (FVTPL):** This class includes financial assets such as derivatives and trading securities that are measured at fair value, with changes in fair value recognized in profit or loss.
- iii. **Financial Liabilities at Amortized Cost:** This class includes financial liabilities such as trade payables, bonds, and loans that are measured at amortized cost.
- iv. **Financial Liabilities at Fair Value through Profit or Loss (FVTPL):** This class includes financial liabilities such as derivatives that are measured at fair value, with changes in fair value recognized in profit or loss.

Level of Disclosure: IFRS 7 requires entities to disclose the following information for each class of financial instrument:

- i. **Carrying Amounts:** The carrying amounts of financial assets and financial liabilities by class.
- ii. **Fair Value:** The fair value of financial assets and liabilities, and the methods used to determine those fair values.
- iii. **Impairment:** Information about impairment losses on financial assets, including the amount of any loss recognized and the factors leading to the impairment.
- iv. **Hedge Accounting:** Information about hedge accounting, including the types of hedges used, the instruments designated as hedging instruments, and the effectiveness of the hedging relationships.

Example: HSBC Holdings, a major global bank, provides detailed disclosures in its financial statements about the classes of financial instruments it holds. For example, HSBC might disclose that it has \$400 billion in loans and receivables classified as financial assets at amortized cost, \$150 billion in derivatives classified as financial assets at FVTPL, and \$300 billion in customer deposits classified as financial liabilities at amortized cost. HSBC would also disclose the fair value of these financial instruments, the methods used to determine fair value, and any impairment losses recognized during the period. For instance, if HSBC recognized an impairment loss of \$2 billion on its loans and receivables, it would provide

detailed information about the factors leading to the impairment and how the loss was calculated.

4.3. Significance of Financial Instruments for Financial Position and Performance:

Impact on Financial Position: Financial instruments can have a significant impact on an entity's financial position. IFRS 7 requires entities to disclose information that helps users understand the impact of financial instruments on the balance sheet, including:

- i. **Total Carrying Amounts:** The total carrying amounts of financial assets and liabilities, broken down by class.
- ii. **Offsetting:** Information about any offsetting arrangements, where financial assets and liabilities are presented on a net basis in the balance sheet.
- iii. **Fair Value Hierarchy:** Information about the level within the fair value hierarchy at which financial instruments are measured, such as Level 1 (quoted prices in active markets), Level 2 (observable inputs), or Level 3 (unobservable inputs).

Impact on Financial Performance: Financial instruments also impact an entity's financial performance, particularly through the recognition of interest income, interest expense, gains or losses on financial instruments, and impairment losses. IFRS 7 requires entities to disclose:

- i. **Net Gains or Losses:** The net gains or losses recognized in profit or loss for each class of financial instrument.
- ii. **Interest Income and Expense:** The total interest income and interest expense recognized during the period.
- iii. **Impairment Losses:** The total impairment losses recognized during the period, and the factors leading to these impairments.

Example: Citigroup Inc., another major global financial institution, provides detailed disclosures about the significance of its financial instruments for its financial position and performance. For example, Citigroup might disclose that it has \$1 trillion in total financial assets and \$900 billion in total financial liabilities. The bank would provide information about the fair value hierarchy for these instruments, showing that \$600 billion of its assets are measured at Level 1, \$300 billion at Level 2, and \$100 billion at Level 3. In terms of financial performance, Citigroup might report that it recognized \$20 billion in net gains on financial instruments at FVTPL, \$15 billion in interest income, \$10 billion in interest

expense, and \$5 billion in impairment losses on loans and receivables. These disclosures help users of the financial statements understand the impact of financial instruments on Citigroup's profitability and financial stability.

4.4. Nature and Extent of Risks Arising from Financial Instruments

Types of Risks: IFRS 7 requires entities to disclose information about the nature and extent of risks arising from financial instruments. The standard identifies several key risks, including:

- i. **Credit Risk:** The risk that one party to a financial instrument will cause a financial loss to the other party by failing to discharge an obligation.
- ii. **Liquidity Risk:** The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
- iii. **Market Risk:** The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices, including interest rate risk, foreign exchange risk, and other price risks.

Risk Management and Disclosures: Entities are required to provide disclosures about their exposure to these risks and how they manage them. This includes:

- i. **Credit Risk Exposure:** Information about the maximum exposure to credit risk, the credit quality of financial assets, and collateral held as security.
- ii. **Liquidity Risk Maturity Analysis:** A maturity analysis for financial liabilities, showing the remaining contractual maturities.
- iii. **Market Risk Sensitivity Analysis:** A sensitivity analysis showing how profit or loss and equity would have been affected by reasonably possible changes in market risk variables.

Example: Barclays PLC, a leading global bank, provides comprehensive disclosures about the risks arising from its financial instruments. For instance, Barclays might disclose that it has \$500 billion in credit exposure, with \$400 billion in loans and receivables and \$100 billion in debt securities. The bank would provide information about the credit quality of these assets, including the percentage that is investment grade versus non-investment grade. In terms of liquidity risk, Barclays might present a maturity analysis showing that it has \$200 billion in financial liabilities maturing within one year, \$300 billion maturing within two to five years, and \$400 billion maturing in more than five years. For market risk, Barclays might provide a sensitivity analysis showing that a 1% increase in interest rates would reduce its profit by \$1 billion, while a 1% decrease in interest rates would increase its profit by \$1.2 billion.

4.5. Transfers of Financial Assets:

Accounting for Transfers: IFRS 7 requires entities to disclose information about transfers of financial assets, particularly when the entity retains some form of continuing involvement in the transferred assets. The disclosures should provide information about the nature of the transferred assets, the risks and rewards retained by the entity, and the impact of the transfer on the financial statements.

Types of Transfers:

- i. **Derecognition:** When an entity transfers a financial asset and derecognizes it from its balance sheet, IFRS 7 requires disclosures about the carrying amounts of the assets derecognized and any continuing involvement.
- ii. **Continuing Involvement:** If the entity retains continuing involvement in the transferred assets, such as through guarantees or options, IFRS 7 requires disclosures about the nature of the continuing involvement, the risks associated with it, and the impact on the entity's financial position and performance.

Example: Assume Deutsche Bank transfers \$100 billion in mortgage-backed securities to a special purpose entity (SPE) but retains a 10% interest in the securities. The bank derecognizes 90% of the securities and recognizes a gain on the transfer, while retaining continuing involvement in 10% of the securities.

Deutsche Bank would disclose the following:

- i. The total amount of securities transferred: \$100 billion.
- ii. The amount derecognized: \$90 billion.
- iii. The continuing involvement: \$10 billion, with details about the nature of the involvement, such as guarantees or retained interests.
- iv. The impact of the transfer on the bank's financial position and performance, including any gains or losses recognized on the transfer.

Summary of the Unit:

IFRS 7 establishes comprehensive disclosure requirements for financial instruments to enhance transparency and risk assessment. It applies to financial assets, liabilities, and equity instruments but excludes interests in subsidiaries, employee benefit plans, and insurance contracts. Entities must classify financial instruments into categories such as amortized cost, fair value through profit or loss (FVTPL), and fair value through other comprehensive income (FVOCI). The standard mandates disclosures on carrying amounts, fair values, impairment losses, hedge accounting, and the significance of financial instruments for financial position and performance. It also requires entities to disclose risks associated with financial instruments, including credit, liquidity, and market risks, along with sensitivity analyses. Real-life applications include banks like HSBC and Citigroup, which disclose detailed information about their financial assets, liabilities, and risk management strategies. IFRS 7 ensures that stakeholders understand the financial impact of an entity's instruments, leading to better investment and regulatory decisions.

Short Questions:

1. What is the primary objective of IFRS 7?
2. Which financial instruments are covered under IFRS 7?
3. Name three key disclosures required for financial instruments under IFRS 7.
4. What is the fair value hierarchy, and why is it important in financial disclosures?
5. How does IFRS 7 improve transparency in financial reporting?
6. What are the different classes of financial instruments that must be disclosed?
7. What types of risks must entities disclose under IFRS 7?
8. Explain the significance of hedge accounting disclosures under IFRS 7.
9. Why is the disclosure of impairment losses on financial assets important?
10. Provide an example of how a bank might disclose its financial instruments under IFRS 7.

Unit: 5

Operating Segments

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UNIT 5: IFRS 8

Operating Segments

Unit Introduction:

IFRS 8, "Operating Segments," is a key accounting standard that enhances transparency by requiring entities to report financial performance based on the segments used for internal decision-making. The standard ensures that financial statements reflect the way management assesses business operations and allocates resources. By adopting a "management approach," IFRS 8 aligns segment reporting with internal financial information reviewed by decision-makers. This approach provides investors and stakeholders with insights into the entity's operational structure and profitability. Publicly traded companies must apply IFRS 8, while other entities may choose to do so voluntarily. For example, Nestlé discloses segment performance across categories like beverages, dairy, and pet care, allowing investors to evaluate the profitability of each division. Similarly, Daimler reports on its automotive and mobility segments, helping stakeholders assess financial performance across its global operations.

OBJECTIVES

By the end of this unit, learners should be able to:

1. Explain the core principle and management approach of IFRS 8.
2. Identify entities required to apply IFRS 8 and its scope limitations.
3. Define and recognize operating segments based on internal management reporting.
4. Apply the quantitative thresholds to determine reportable segments.
5. Interpret the disclosure requirements for segment revenue, profit or loss, assets, and liabilities.

5.1. Core Principle of IFRS 8:

- i. **Overview of the Core Principle:** The core principle of IFRS 8 "Operating Segments" is to provide information about the financial performance and position of an entity's business activities, as seen through the eyes of the entity's management. The standard aims to enhance the transparency of financial statements by requiring entities to disclose information about the components of the business that management uses to make decisions and assess performance.
- ii. **Management Approach:** IFRS 8 adopts a "management approach" to segment reporting, meaning that the segments reported are those that management considers when allocating resources and assessing performance. This approach aligns external reporting with internal decision-making processes, providing users of financial statements with insights into how the entity is managed and how resources are deployed across different segments.
- iii. **Importance for Stakeholders:** For investors and other stakeholders, the core principle of IFRS 8 ensures that they receive relevant information about the key areas of the business that drive performance. By understanding the entity's operating segments, stakeholders can better assess the risks and opportunities associated with different parts of the business, leading to more informed investment decisions.
- iv. **Practical Example:** Consider Nestlé S.A., a Swiss multinational food and beverage company. Nestlé operates in multiple segments, including beverages, milk products and ice cream, nutrition and health science, prepared dishes and cooking aids, confectionery, and pet care. Under IFRS 8, Nestlé must disclose information about these segments, including their revenue, profit or loss, and assets. This information allows stakeholders to understand which segments contribute most to Nestlé's overall performance and how resources are allocated across different product lines.

5.2. Scope of IFRS 8:

- i. **Entities Required to Apply IFRS 8:** IFRS 8 applies to entities whose equity or debt securities are publicly traded or that are in the process of issuing equity or debt securities in public markets. The standard also applies to entities that voluntarily provide segment information in their financial statements.

- ii. **Exclusions from Scope:** Entities that do not meet the criteria for public trading are not required to apply IFRS 8, although they may choose to do so voluntarily. This exclusion recognizes that smaller entities or those not involved in public capital markets may not have the same reporting needs or resources as publicly traded companies.
- iii. **Practical Example - Application in Europe:** Daimler AG, a German multinational automotive corporation, applies IFRS 8 in its financial reporting. Daimler's shares are publicly traded on the Frankfurt Stock Exchange, making the company subject to the requirements of IFRS 8. The company reports on various segments, including Mercedes-Benz Cars & Vans, Daimler Trucks & Buses, and Daimler Mobility, providing detailed information about each segment's financial performance and position.

5.3. Operating Segment:

- i. **Definition of an Operating Segment:** An operating segment is a component of an entity that:
 - a. Engages in business activities from which it may earn revenues and incur expenses.
 - b. Has its operating results regularly reviewed by the entity's chief operating decision-maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance.
 - c. Has discrete financial information available.
- ii. **Identification of Operating Segments:** The identification of operating segments is based on how the entity's management structures the business and evaluates its performance. The CODM, typically the CEO or top management team, uses the financial information of these segments to make key decisions.
- iii. **Aggregation Criteria:** In some cases, operating segments with similar economic characteristics may be aggregated into a single segment for reporting purposes if they meet specific criteria, such as similar products or services, production processes, customer types, distribution methods, and regulatory environments.
- iv. **Practical Example:** Vodafone Group Plc, a British multinational telecommunications company, identifies its operating segments based on geographical regions. Vodafone's segments include Europe, Africa, Asia Pacific, and Other Markets. Each segment engages in the provision of

telecommunications services, and the results of these segments are reviewed by Vodafone's CODM to make decisions about resource allocation and performance evaluation. The discrete financial information for each region allows Vodafone to assess the profitability and growth potential of its operations in different parts of the world.

5.4. Reportable Segments:

- i. **Criteria for Reportable Segments:** Once operating segments are identified, they must be evaluated to determine if they are reportable. An operating segment is reportable if it meets any of the following quantitative thresholds:
 - a. **Revenue:** The segment's reported revenue, including sales to external customers and intersegment sales, is 10% or more of the combined revenue of all operating segments.
 - b. **Profit or Loss:** The absolute amount of the segment's reported profit or loss is 10% or more of the greater of the combined reported profit of all operating segments that did not report a loss or the combined reported loss of all operating segments that reported a loss.
 - c. **Assets:** The segment's assets are 10% or more of the combined assets of all operating segments.
- ii. **Aggregation of Segments:** If an operating segment does not meet the quantitative thresholds, it may still be considered reportable if management believes that the information about the segment would be useful to users of the financial statements. Additionally, if the total external revenue reported by operating segments constitutes less than 75% of the entity's total revenue, additional segments must be reported until at least 75% of the total revenue is included in reportable segments.
- iii. **Practical Example - Royal Dutch Shell:** Royal Dutch Shell, a British-Dutch multinational oil and gas company, reports on several segments, including Integrated Gas, Upstream, Downstream, and Corporate. The company applies the quantitative thresholds of IFRS 8 to determine which segments are reportable. For instance, the Upstream segment, which involves exploration and production of crude oil and natural gas, generates significant revenue and holds substantial assets, making it a reportable segment. In a given year, Shell's Upstream segment might generate \$50

billion in revenue, which exceeds the 10% threshold when compared to the combined revenue of all segments. Additionally, the segment's assets might total \$100 billion, also surpassing the 10% threshold for combined segment assets. As a result, Shell provides detailed disclosures about the Upstream segment, including its revenue, profit or loss, and assets.

5.5. Disclosures:

IFRS 8 requires entities to provide a range of disclosures for each reportable segment. These disclosures include:

- i. **Segment Revenue:** Total revenue from external customers and intersegment sales, with a reconciliation to the entity's consolidated revenue.
- ii. **Segment Profit or Loss:** A measure of segment profit or loss, with a reconciliation to the entity's consolidated profit or loss.
- iii. **Segment Assets and Liabilities:** Total assets and liabilities for each reportable segment, with a reconciliation to the entity's consolidated assets and liabilities.
- iv. **Other Segment Information:** Information about non-current assets, additions to non-current assets, depreciation and amortization, and other material items.
- v. **Reconciliations:** Entities must provide reconciliations of the total segment revenue, profit or loss, assets, and liabilities to the corresponding amounts in the consolidated financial statements. These reconciliations ensure that users of the financial statements can understand the relationship between segment information and the overall financial position and performance of the entity.

Practical Example: Siemens AG, a German multinational conglomerate, provides detailed segment disclosures in its financial statements. Siemens operates in multiple segments, including Digital Industries, Smart Infrastructure, Mobility, and Siemens Healthineers. For each reportable segment, Siemens discloses segment revenue, profit or loss, and assets, along with reconciliations to the consolidated financial statements.

For example, in a given year, Siemens might report €40 billion in revenue for its Digital Industries segment, with €35 billion from external customers and €5 billion from intersegment sales. The segment's profit might be €5 billion, with total assets of €60 billion. Siemens would then reconcile these figures to the consolidated

revenue, profit, and assets, providing users with a clear understanding of how the segment contributes to the overall financial performance of the company.

5.6. Measurement:

- i. **Consistency in Measurement:** IFRS 8 requires that the amounts reported for each segment be measured on the same basis as the internal financial information used by the CODM. This ensures consistency between internal management reports and external financial reporting. The measurement of segment items should be consistent with the accounting policies adopted for preparing the entity's financial statements.
- ii. **Allocation of Costs:** The standard allows entities to allocate costs to segments based on reasonable and consistent methods. However, entities must disclose the basis for allocating costs if the allocation method is material to the understanding of segment information.
- iii. **Practical Example:** Tata Motors Limited, an Indian multinational automotive manufacturing company, applies IFRS 8 in its segment reporting. Tata Motors identifies segments such as Passenger Vehicles, Commercial Vehicles, and Jaguar Land Rover. The company measures segment revenue, profit, and assets based on the same accounting policies used in its consolidated financial statements. For instance, Tata Motors might allocate corporate overheads to segments based on the segment's revenue contribution. If the Passenger Vehicles segment generates Rs.30,000 crore in revenue, representing 60% of total revenue, and the total corporate overheads are Rs. 500 crore, Tata Motors might allocate Rs. 300 crore of corporate overheads to the Passenger Vehicles segment. This allocation is disclosed in the segment information, ensuring transparency in how costs are attributed to different parts of the business.

5.7. Entity-Wide Disclosures:

Non-Segment-Specific Disclosures: IFRS 8 requires certain disclosures that apply to the entity as a whole, rather than specific segments. These entity-wide disclosures include:

- i. **Revenue Information:** Information about revenues from external customers for each product and service, or each group of similar products and services.

- ii. **Geographical Information:** Revenues from external customers and non-current assets attributed to the entity's country of domicile and all foreign countries where the entity generates revenue or holds assets.
- iii. **Major Customers:** Information about major customers that account for 10% or more of total revenue, including the total revenue from each such customer.
- iv. Entity-wide disclosures provide a broader context for understanding the entity's overall financial performance and position. They complement segment-specific information by offering insights into the entity's product lines, geographical diversification, and dependence on major customers.

5.8 Conclusion:

- i. **Comprehensive Understanding of IFRS 8:** IFRS 8 "Operating Segments" is a crucial standard for enhancing the transparency and comparability of financial statements. By requiring detailed disclosures about operating segments, IFRS 8 ensures that stakeholders have access to relevant information about the entity's business activities, how they are managed, and how they contribute to the entity's overall financial performance and position.
- ii. **Real-Life Applications and Financial Impact:** The Practical Examples provided throughout this document illustrate how companies across various industries and jurisdictions apply IFRS 8 to report on their operating segments. These examples demonstrate the practical application of the standard, highlighting the importance of segment information in understanding an entity's financial health and strategic direction.
- iii. **Future Considerations:** As businesses continue to evolve and diversify, the application of IFRS 8 will remain critical in ensuring that segment information is reported transparently and consistently. Companies must continue to refine their segment reporting practices to meet the expectations of stakeholders and comply with international financial reporting standards.

Unit Summary:

IFRS 8 requires companies to disclose financial information based on their internal operating segments. This "management approach" aligns external reporting with internal decision-making. Entities with publicly traded securities must apply IFRS 8, ensuring transparency in segment profitability and resource allocation. Operating segments are identified based on how management evaluates business performance. If a segment's revenue, profit, or assets exceed 10% of the total, it must be reported separately. Additional disclosures include segment revenues, assets, liabilities, and reconciliations to consolidated financial statements. Companies like Vodafone report segments based on geographical regions, while Shell discloses separate financials for its upstream and downstream businesses. These disclosures help stakeholders assess business risks and opportunities. IFRS 8 enhances comparability and investor confidence by ensuring consistent segment reporting across industries.

Short Questions:

1. What is the core principle of IFRS 8?
2. How does the "management approach" influence segment reporting under IFRS 8?
3. Which entities are required to apply IFRS 8?
4. What criteria must be met for a business component to be classified as an operating segment?
5. What are the three quantitative thresholds for identifying reportable segments?
6. Why does IFRS 8 require reconciliations between segment and consolidated financial statements?
7. What disclosures must companies provide for each reportable segment?
8. How does IFRS 8 enhance investor decision-making?
9. Provide an example of a company applying IFRS 8 to its segment reporting.
10. Why do some companies voluntarily disclose segment information even if not required?

Unit: 6

Consolidated Financial Statements

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UNIT 6: IFRS 10

Consolidated Financial Statements

Unit Introduction:

IFRS 10, "Consolidated Financial Statements," establishes principles for preparing and presenting consolidated financial statements when an entity controls one or more other entities. It introduces a single control model applicable to all entities, ensuring consistency in determining whether an entity should be consolidated. The standard defines control based on three key factors: power over the investee, exposure to variable returns, and the ability to influence those returns. This principle helps businesses provide an accurate picture of their financial position and performance. IFRS 10 also includes special provisions for investment entities, allowing them to measure subsidiaries at fair value rather than consolidating them. This exception helps investment firms, private equity funds, and hedge funds provide relevant financial reporting. By improving transparency and comparability, IFRS 10 enhances investor confidence and enables stakeholders to assess the financial health of a group of entities accurately.

OBJECTIVES

By the end of this unit, learners should be able to:

1. Explain the core objective and scope of IFRS 10.
2. Identify the key criteria for determining control under IFRS 10.
3. Describe the accounting requirements for consolidation, including eliminating intragroup transactions.
4. Understand the investment entity exception and when it applies.
5. Analyze real-world applications of IFRS 10 in different industries.

6.1. Objective of IFRS 10:

- i. **Core Objective:** The primary objective of IFRS 10 "Consolidated Financial Statements" is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. The standard aims to ensure that the financial statements provide a true and fair view of the financial position, performance, and cash flows of a group of entities that are controlled by a single parent entity.
- ii. **Unified Control Concept:** IFRS 10 introduces a single control model that applies to all entities, including special purpose entities (SPEs). The standard defines control as the basis for determining which entities are consolidated and how they are consolidated, emphasizing the importance of consistent application across different types of entities.
- iii. **Enhancing Comparability and Transparency:** By establishing a single control model, IFRS 10 enhances the comparability and transparency of consolidated financial statements, providing users with a clear and consistent view of the financial position and performance of a group of entities.
- iv. **Practical Example:** Consider a multinational corporation, such as Unilever, which operates through a complex network of subsidiaries, joint ventures, and associates. The objective of IFRS 10 ensures that Unilever consolidates all entities it controls into a single set of financial statements, providing a comprehensive view of the group's overall financial health. For example, Unilever might have subsidiaries in different countries, such as Hindustan Unilever in India and Unilever Brasil in Brazil. By applying IFRS 10, Unilever consolidates these subsidiaries into its financial statements, reflecting the group's total assets, liabilities, revenue, and profit.

62. Scope of IFRS 10:

IFRS 10 applies to all entities that are required to prepare consolidated financial statements, regardless of their nature, purpose, or industry. This includes entities that control one or more other entities, such as parent companies, investment entities, and entities with special purpose vehicles (SPVs). There are specific exclusions from the scope of IFRS 10, including:

- i. Investment entities that are exempt from preparing consolidated financial statements (discussed later).

- ii. Entities that do not control other entities or have no subsidiaries are not required to apply IFRS 10.

Consider Deutsche Bank, a major German multinational investment bank, which controls various subsidiaries across the globe. Deutsche Bank applies IFRS 10 to prepare consolidated financial statements that include its banking subsidiaries, asset management entities, and other controlled entities. However, if Deutsche Bank holds investments in entities without controlling interest (e.g., minority stakes in financial institutions), these investments would be accounted for under other relevant IFRS standards rather than being consolidated under IFRS 10.

6.3. Control”

- i. **Definition of Control:** Control is the key concept that determines whether an entity consolidates another entity in its financial statements. Under IFRS 10, an entity controls another entity if it has all of the following:
 - a. **Power Over the Investee:** The ability to direct the relevant activities of the investee, which are the activities that significantly affect the investee’s returns.
 - b. **Exposure to Variable Returns:** The entity is exposed, or has rights, to variable returns from its involvement with the investee.
 - c. **Ability to Use Power to Affect Returns:** The entity has the ability to use its power over the investee to affect the amount of the entity's returns.
- ii. **Assessing Control:** Determining control involves a thorough assessment of the contractual arrangements, voting rights, and other relevant factors. This includes considering potential voting rights, the power to appoint key management personnel, and other mechanisms that may grant control over the investee.
- iii. **Practical Example:** Apple Inc., a leading technology company, controls various subsidiaries worldwide that develop, manufacture, and sell Apple products. For instance, Apple might have a subsidiary in Ireland that manages European operations. Apple controls this subsidiary because it has the power to direct its relevant activities (e.g., product development, marketing), is exposed to variable returns (e.g., profits from European sales), and has the ability to affect those returns through its control over strategic decisions. Suppose Apple holds 75% of the voting rights in this subsidiary, while the remaining 25% is held by non-controlling interests.

The power granted by its majority voting rights allows Apple to control the subsidiary, leading to its consolidation in Apple's financial statements.

6.4. Accounting Requirements:

IFRS 10 outlines specific consolidation procedures that entities must follow when preparing consolidated financial statements. These procedures include:

- i. **Elimination of Intragroup Transactions:** Intragroup balances, transactions, income, and expenses must be eliminated in full to avoid double counting.
- ii. **Uniform Accounting Policies:** The parent entity and its subsidiaries must apply uniform accounting policies for similar transactions and events.
- iii. **Non-Controlling Interests:** Non-controlling interests in the net assets of subsidiaries are presented separately in the consolidated statement of financial position, and their share of profit or loss is separately disclosed in the consolidated statement of profit or loss.

Practical Example: Procter & Gamble (P&G), a global consumer goods company, consolidates its subsidiaries worldwide into its financial statements. For example, P&G might have a subsidiary in Japan that produces and sells P&G products in the Asia-Pacific region. When preparing its consolidated financial statements, P&G eliminates intragroup transactions between the parent company and its Japanese subsidiary, such as internal sales of raw materials or finished goods. If P&G's Japanese subsidiary generates ¥100 billion in revenue from external customers and ¥20 billion from sales to the parent company, only the ¥100 billion from external sales is included in the consolidated revenue, while the ¥20 billion intragroup sales are eliminated.

Non-Controlling Interests: Assume P&G owns 80% of its Japanese subsidiary, with the remaining 20% held by non-controlling interests. The non-controlling interests' share of profit, say ¥5 billion, is presented separately in P&G's consolidated statement of profit or loss, and their share of the net assets is disclosed in the consolidated statement of financial position.

6.5. Determining Whether an Entity is an Investment Entity:

Investment Entity Definition: An investment entity is an entity that:

- i. **Obtains Funds from Investors:** Provides them with investment management services.

- ii. **Commits to Investing Funds:** Invests in a portfolio of assets to generate returns from capital appreciation, investment income, or both.
- iii. **Measures Performance on a Fair Value Basis:** Measures and evaluates the performance of substantially all of its investments on a fair value basis.

Characteristics of an Investment Entity: While the definition provides a framework, certain characteristics are typically present in an investment entity:

- i. **Multiple Investments:** The entity holds multiple investments to diversify risk.
- ii. **Multiple Investors:** The entity has more than one investor, pooling funds for investment.
- iii. **Unrelated Investors:** The investors are not related parties of the entity.
- iv. **Ownership Interests:** The entity holds investments as ownership interests, such as equity or debt securities.

Practical Example - Private Equity Industry: CVC Capital Partners, a global private equity firm, is an example of an investment entity under IFRS 10. CVC raises funds from institutional investors, such as pension funds and endowments, to invest in a diversified portfolio of companies across various industries. The firm commits to generating returns through capital appreciation and investment income, primarily by acquiring, improving, and selling companies at a profit. CVC measures the performance of its portfolio companies on a fair value basis, regularly revaluing investments based on market conditions, company performance, and other relevant factors. Because CVC meets the definition and characteristics of an investment entity, it applies the investment entity exception to consolidation, as discussed in the next section.

6.6. Investment Entities: Exception to Consolidation

Exception to Consolidation: IFRS 10 provides an exception to the general requirement for consolidation for entities that qualify as investment entities. Instead of consolidating its subsidiaries, an investment entity measures its investments in those subsidiaries at fair value through profit or loss in accordance with IFRS 9 "Financial Instruments."

Conditions for Applying the Exception: To apply the exception, the following conditions must be met:

- i. **The Parent Entity is an Investment Entity:** The parent must meet the definition of an investment entity.

- ii. **The Subsidiaries are Not Providing Services Relating to the Parent's Investment Activities:** The exception does not apply if a subsidiary provides investment-related services or engages in investment activities other than those related to the parent entity's own investments.

Practical Example - Real Estate Investment Trust (REIT): Consider Blackstone Group, a global investment firm with multiple investment entities, including real estate investment trusts (REITs). A specific Blackstone REIT might own a diversified portfolio of commercial properties, generating returns for its investors through rental income and property appreciation. Because the REIT qualifies as an investment entity, it applies the exception to consolidation. Instead of consolidating each property-owning subsidiary, the REIT measures these investments at fair value through profit or loss. For example, if the REIT holds a property subsidiary valued at \$200 million at the beginning of the year, and the property's fair value increases to \$220 million by year-end, the REIT recognizes a \$20 million gain in its profit or loss.

Impact on Financial Statements: The use of the investment entity exception results in significant differences in the presentation of financial statements. For example, instead of presenting consolidated financial statements that include each property subsidiary's assets, liabilities, revenue, and expenses, the REIT presents its investments in these subsidiaries as a single line item measured at fair value. This approach provides a clearer picture of the investment performance of the REIT's portfolio, as the fair value measurement reflects the current market value of the properties rather than historical cost or carrying amounts.

6.7. Additional Considerations and Challenges in Applying IFRS 10:

- i. **Challenges in Determining Control:** One of the key challenges in applying IFRS 10 is determining whether control exists, particularly in complex structures involving multiple entities, special purpose vehicles (SPVs), and other arrangements. Entities must carefully assess all relevant facts and circumstances, including potential voting rights, contractual arrangements, and the ability to influence key decisions.
- ii. **Practical Example - Energy Industry:** Consider Royal Dutch Shell, a British Dutch multinational oil and gas company, which participates in joint ventures and consortiums for exploration and production activities. Determining whether Shell controls a joint venture can be challenging,

especially when decision-making authority is shared among multiple parties.

For example, Shell might hold a 40% stake in a joint venture with other energy companies, with each partner having significant influence over decisions. To determine whether Shell controls the joint venture, the company must assess whether it has the power to direct the relevant activities, its exposure to variable returns, and its ability to use power to affect those returns.

- iii. **Complexities in Applying the Investment Entity Exception:** Another challenge arises in determining whether an entity qualifies as an investment entity and whether the exception to consolidation should be applied. This determination requires careful consideration of the entity's business model, investment strategy, and the nature of its subsidiaries.
- iv. **Practical Example:** A hedge fund managed by a large financial institution might qualify as an investment entity under IFRS 10. The hedge fund pools capital from multiple investors to invest in a diversified portfolio of securities. However, if the hedge fund establishes a subsidiary to manage its investment activities, the subsidiary might not qualify for the investment entity exception if it provides services beyond those related to the hedge fund's investments.

For instance, if the subsidiary also manages investments for third parties or engages in proprietary trading, the hedge fund might be required to consolidate the subsidiary's financial statements, even though it applies the investment entity exception to its other subsidiaries.

6.8. Case Studies and Examples

Case Study 1: Consolidation of a Global Retailer - Inditex Inditex, a Spanish multinational clothing company that owns brands like Zara and Massimo Dutti, operates through numerous subsidiaries worldwide. Under IFRS 10, Inditex consolidates all subsidiaries where it has control, ensuring that the consolidated financial statements present a comprehensive view of the group's financial position and performance. For example, Inditex might own 100% of a subsidiary in Japan that operates Zara stores. The subsidiary's revenue of ¥50 billion, expenses of ¥30 billion, and net assets of ¥20 billion are fully consolidated into Inditex's financial statements. Intragroup transactions, such as the sale of clothing inventory from the

parent company to the Japanese subsidiary, are eliminated in the consolidation process.

Case Study 2: Investment Entity Exception - Bridgewater Associates

Bridgewater Associates, a large hedge fund manager based in the United States, operates several investment funds that qualify as investment entities under IFRS 10. Each fund pools capital from institutional investors to invest in a diversified portfolio of assets, such as equities, bonds, and derivatives. Because these funds meet the definition of investment entities, they apply the exception to consolidation. Instead of consolidating the underlying investments, Bridgewater measures each fund's investments at fair value through profit or loss. For example, if a fund holds \$500 million in equities and their fair value increases to \$550 million during the year, the fund recognizes a \$50 million gain in its profit or loss, without consolidating the financial statements of each equity investee.

Case Study 3: Determining Control in a Joint Venture - BP BP, a British multinational oil and gas company, participates in joint ventures for oil exploration and production activities in various regions, such as the Middle East. Determining whether BP controls a joint venture can be complex, especially when other partners have significant influence.

Suppose BP holds a 50% stake in a joint venture with another oil company, with both partners having equal voting rights. BP would need to assess whether it has the power to direct the relevant activities of the joint venture, such as exploration decisions, production levels, and sales agreements. If BP concludes that it does not have control, it would not consolidate the joint venture but instead account for its interest using the equity method.

6.9 Conclusion:

- i. **Comprehensive Understanding of IFRS 10:** IFRS 10 "Consolidated Financial Statements" provides a robust framework for determining control, preparing consolidated financial statements, and addressing specific scenarios, such as the investment entity exception. The standard's emphasis on a single control model ensures that entities consistently and transparently consolidate their subsidiaries, providing users with a comprehensive view of the group's financial position and performance.
- ii. **Real-Life Applications and Financial Impact:** The Practical Examples and case studies discussed in this document illustrate how companies across various industries apply IFRS 10 to consolidate their subsidiaries, determine

control, and apply the investment entity exception. These examples highlight the practical challenges and complexities in applying the standard, particularly in determining control and managing investment entities.

- iii. **Future Considerations:** As businesses continue to evolve and enter into increasingly complex structures and arrangements, the application of IFRS 10 will remain critical in ensuring that consolidated financial statements accurately reflect the financial reality of the group. Companies must stay vigilant in assessing control, managing investment entities, and ensuring compliance with IFRS 10 to meet the expectations of stakeholders and regulators.

Summary of the Unit

IFRS 10 establishes a single control model for determining when an entity should consolidate another entity into its financial statements. Control is defined as having power over the investee, exposure to variable returns, and the ability to use power to affect those returns. The standard applies to all entities required to prepare consolidated financial statements, with an exception for investment entities that measure subsidiaries at fair value. Consolidation requires eliminating intragroup transactions, applying uniform accounting policies, and presenting non-controlling interests separately. Real-life cases, such as Unilever, Apple, and Deutsche Bank, illustrate how IFRS 10 is applied in various industries. By providing a clear framework for consolidation, IFRS 10 enhances transparency, ensures consistency, and helps stakeholders assess the financial position of a group accurately.

Short Questions:

1. What is the primary objective of IFRS 10?
2. What are the three key factors used to determine control under IFRS 10?
3. How does IFRS 10 improve the transparency of consolidated financial statements?
4. What types of entities are required to apply IFRS 10?
5. What is the investment entity exception under IFRS 10?
6. How are intragroup transactions treated in consolidated financial statements?
7. Provide an example of a multinational company that applies IFRS 10.
8. What is the impact of non-controlling interests on consolidated financial statements?
9. How does IFRS 10 apply to private equity firms?
10. What challenges do companies face when determining control under IFRS 10?

Unit: 7

Disclosure of Interests in Other Entities

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Unit 7: IFRS 12

Disclosure of Interests in Other Entities

Unit Introduction:

IFRS 12, "Disclosure of Interests in Other Entities," is an essential financial reporting standard that enhances transparency by requiring entities to disclose information about their interests in subsidiaries, joint arrangements, associates, and unconsolidated structured entities. The standard helps investors and stakeholders assess the risks, financial effects, and strategic significance of these interests. By mandating detailed disclosures, IFRS 12 enables users of financial statements to understand the nature of an entity's involvement in other entities, the potential risks associated with these relationships, and how they impact the entity's financial position and performance. This is particularly important for multinational corporations with complex business structures. For instance, Volkswagen Group applies IFRS 12 by disclosing detailed information about its subsidiaries (such as Porsche and Audi), joint ventures in China, and significant associate interests. These disclosures provide insights into how Volkswagen's global operations contribute to its consolidated financial performance, allowing investors to make informed decisions.

OBJECTIVES

By the end of this unit, learners should be able to:

1. Explain the objective and scope of IFRS 12 in financial reporting.
2. Identify the key disclosure requirements for interests in subsidiaries, joint arrangements, associates, and unconsolidated structured entities.
3. Assess the importance of significant judgments and assumptions in determining control, joint control, or significant influence.
4. Analyze the financial impact of non-controlling interests and structured entities on consolidated financial statements.
5. Interpret real-life applications of IFRS 12, including disclosures in multinational corporations.

7.1. Objective of IFRS 12”

The primary objective of IFRS 12 is to require entities to disclose information that enables users of financial statements to evaluate the nature and risks associated with an entity’s interests in other entities. Additionally, the standard aims to provide transparency regarding the effects of those interests on the entity’s financial position, performance, and cash flows.

IFRS 12 focuses on the following key areas of disclosure:

- i. **Interests in Subsidiaries:** Information about the composition of the group, control over subsidiaries, and any non-controlling interests.
- ii. **Interests in Joint Arrangements and Associates:** Information about the nature and financial effects of an entity's interests in joint ventures and associates.
- iii. **Interests in Unconsolidated Structured Entities:** Information about the nature of the risks associated with an entity’s involvement in structured entities that are not consolidated.

By requiring detailed disclosures, IFRS 12 helps investors and other stakeholders understand how an entity’s interests in other entities affect its overall financial health. The standard ensures that users can assess the financial impact, risks, and potential exposures resulting from these relationships. Consider Volkswagen Group, a German multinational automotive company, which has numerous subsidiaries, joint ventures, and associates worldwide. Volkswagen’s application of IFRS 12 ensures that the company discloses detailed information about its interests in these entities, including the financial impact of non-controlling interests in subsidiaries like Porsche and Audi, joint ventures in China, and associates in various regions. These disclosures provide stakeholders with a clear understanding of how Volkswagen's global operations contribute to its consolidated financial performance.

7.2. Scope of IFRS 12:

- i. **Entities Required to Apply IFRS 12:** IFRS 12 applies to entities that have interests in subsidiaries, joint arrangements, associates, or unconsolidated structured entities. The standard encompasses a wide range of relationships between an entity and other entities, covering both consolidated and unconsolidated entities.
- ii. **Applicability Across Reporting Entities:** The standard is applicable to all entities that prepare consolidated financial statements or separate financial

statements. This includes parent entities that control one or more subsidiaries, entities with joint ventures or associates, and entities involved in structured arrangements.

- iii. **Exclusions from Scope:** IFRS 12 does not apply to interests in entities that are solely investments held for sale under IFRS 5 "Non-current Assets Held for Sale and Discontinued Operations." Additionally, the standard does not apply to short-term investments in entities that do not involve significant influence or control.
- iv. **Practical Example - Application in the Telecom Industry:** Vodafone Group Plc, a British multinational telecommunications company, applies IFRS 12 in its financial reporting. Vodafone has interests in several joint ventures, associates, and subsidiaries across various countries, including a significant stake in Vodafone Idea Limited in India and joint ventures in European markets. IFRS 12 ensures that Vodafone provides detailed disclosures about these interests, including the financial impact, risks, and strategic importance of these entities to Vodafone's overall business operations.

7.3. Significant Judgments and Assumptions:

Importance of Judgments and Assumptions: IFRS 12 requires entities to disclose significant judgments and assumptions made when determining whether they control another entity, have joint control over an arrangement, or exercise significant influence over another entity. These judgments are crucial because they affect whether an entity consolidates another entity, applies equity accounting, or discloses interests in unconsolidated structured entities.

Key Areas of Judgment:

- i. **Control Assessment:** Determining whether the entity controls another entity, which involves assessing the power over the investee, exposure to variable returns, and the ability to affect those returns.
- ii. **Joint Control:** Assessing whether the entity shares control of an arrangement with another party and whether the arrangement is a joint operation or a joint venture.
- iii. **Significant Influence:** Evaluating whether the entity has the power to participate in the financial and operating policy decisions of another entity without having control or joint control.

Disclosure of Judgments: Entities must disclose the significant judgments made in determining the classification of their interests in other entities, including the key factors considered and any changes in judgments from previous reporting periods.

Practical Example - Financial Services Industry: In the case of Banco Santander, a major Spanish banking group, significant judgments are made in determining control over its numerous subsidiaries, joint ventures, and associates across Europe, Latin America, and North America. For instance, Banco Santander's assessment of control over its subsidiary Santander Brasil involves evaluating its power to direct relevant activities, its exposure to variable returns through dividends and share price appreciation, and its ability to influence those returns through its ownership stake. These judgments are disclosed in Santander's financial statements, providing transparency about the basis for consolidating Santander Brasil and other entities within the group.

7.4. Interests in Subsidiaries:

IFRS 12 requires entities to disclose information about their interests in subsidiaries, including:

- i. **Composition of the Group:** A list of significant subsidiaries, including the name, country of incorporation, and proportion of ownership interest.
- ii. **Non-Controlling Interests:** Information about non-controlling interests in subsidiaries, including the proportion of voting rights, the profit or loss attributable to non-controlling interests, and the carrying amount of non-controlling interests in the consolidated financial statements.
- iii. **Changes in Ownership Interests:** Disclosures about changes in ownership interests in subsidiaries that do not result in a loss of control, including the effect on the equity attributable to the parent.

The standard emphasizes the importance of disclosing the financial impact of non-controlling interests, as these can significantly affect the consolidated results of the parent entity.

Practical Example: Unilever, a British-Dutch multinational consumer goods company, has numerous subsidiaries worldwide, including significant non-controlling interests in some of its regional subsidiaries. For example, Unilever's subsidiary Hindustan Unilever Limited (HUL) operates in India, with a significant portion of its shares held by non-controlling interests. In its financial statements, Unilever discloses the proportion of ownership in HUL, the profit or loss attributable to non-controlling interests, and the carrying amount of these interests.

Assume HUL generates €5 billion in revenue and €1 billion in profit, with 30% held by non-controlling interests. Unilever would disclose that €300 million of the profit is attributable to non-controlling interests, providing a clear picture of the financial impact of these interests on Unilever's consolidated financial performance.

7.5. Interests in Unconsolidated Subsidiaries (Investment Entities)

Understanding Investment Entities: An investment entity is an entity whose business purpose is to invest funds solely for returns from capital appreciation, investment income, or both. IFRS 12 requires investment entities to disclose their interests in unconsolidated subsidiaries, including information about the nature and extent of these interests and the associated risks.

Disclosure Requirements:

- i. **Nature of Interests:** Information about the type of unconsolidated subsidiaries, their principal place of business, and the nature of the relationship with the investment entity.
- ii. **Financial Impact:** Disclosures about the carrying amount of interests in unconsolidated subsidiaries and the income generated from these investments.
- iii. **Risks Associated with Interests:** Information about the risks associated with unconsolidated subsidiaries, including credit risk, liquidity risk, and market risk.

Practical Example: Consider a European private equity firm that qualifies as an investment entity under IFRS. The firm holds significant stakes in various unconsolidated subsidiaries across different industries, such as technology, healthcare, and manufacturing. The private equity firm discloses detailed information about these unconsolidated subsidiaries, including their names, principal places of business, and the nature of the investments.

For example, the firm might hold a 40% stake in a technology startup with a carrying amount of €100 million. The income generated from this investment, including dividends and capital gains, is disclosed in the financial statements. Additionally, the firm provides information about the risks associated with the investment, such as market volatility and the startup's ability to achieve its growth targets.

7.6. Interests in Joint Arrangements and Associates:

Types of Joint Arrangements: IFRS 12 requires entities to disclose information about their interests in joint arrangements, which can be classified as:

- i. **Joint Operations:** Where the parties to the arrangement have rights to the assets and obligations for the liabilities.
- ii. **Joint Ventures:** Where the parties have rights to the net assets of the arrangement.

Disclosure Requirements: Entities must disclose the nature and extent of their interests in joint arrangements and associates, including:

- i. **Nature of Relationships:** Information about the type of joint arrangements or associates, the principal place of business, and the proportion of ownership interest.
- ii. **Financial Impact:** Disclosures about the carrying amount of interests in joint ventures and associates, the share of profit or loss, and other comprehensive income.
- iii. **Risks and Contingencies:** Information about risks associated with joint arrangements and associates, including any contingent liabilities and commitments.

Practical Example - Energy Industry: BP plc, a British multinational oil and gas company, has several joint ventures and associates in the energy sector. For instance, BP is involved in a joint venture with Rosneft, a Russian oil company, in which it holds a significant equity interest. BP discloses detailed information about this joint venture, including its proportionate share of revenue, profit, and assets. Assume BP's share of the joint venture generates \$10 billion in revenue and \$2 billion in profit. BP would disclose this information in its financial statements, including the carrying amount of its investment in the joint venture, which might be \$15 billion. Additionally, BP would provide details about any risks associated with the joint venture, such as geopolitical risks, fluctuations in oil prices, and regulatory changes in the energy sector.

Associate Interests: In addition to joint ventures, BP also has significant interests in associates, where it exerts significant influence but does not have control. For example, BP might hold a 30% stake in an associate involved in renewable energy, with a carrying amount of \$5 billion. BP would disclose its share of the associate's profit or loss, which might be \$500 million, as well as its share of other comprehensive income, such as gains or losses on foreign currency translation.

Disclosure of Contingent Liabilities and Commitments: BP also discloses any contingent liabilities and commitments related to its joint ventures and associates. For instance, if BP has committed to providing additional funding to a joint venture in the event of a cash shortfall, this commitment would be disclosed, along with the potential impact on BP's financial position.

7.7. Interests in Unconsolidated Structured Entities:

Understanding Unconsolidated Structured Entities: Unconsolidated structured entities are entities that have been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity. Instead, control is established through contractual arrangements or other means. These entities are often used in securitization, asset-backed financing, or other complex financial arrangements.

Disclosure Requirements: IFRS 12 requires entities to disclose information about their interests in unconsolidated structured entities, including:

- i. **Nature of Interests:** Information about the nature of the entity's involvement in structured entities, the purpose of the structured entities, and how they are financed.
- ii. **Financial Impact:** Disclosures about the carrying amount of interests in structured entities, the income generated from these interests, and the maximum exposure to loss.
- iii. **Risks and Risk Management:** Information about the risks associated with structured entities, including credit risk, liquidity risk, and how the entity manages these risks.

Practical Example - Financial Services Industry: Deutsche Bank AG, a German multinational investment bank and financial services company, is involved in several unconsolidated structured entities, particularly in the context of securitization and asset-backed financing. Deutsche Bank might disclose its involvement in a structured entity designed to securitize a pool of mortgage loans. For example, Deutsche Bank might hold a \$500 million interest in the structured entity, which generates \$50 million in income annually. The bank would disclose the nature of the structured entity, its purpose (e.g., securitizing residential mortgage loans), and how it is financed (e.g., issuing mortgage-backed securities to investors). Deutsche Bank would also provide information about the risks associated with the structured entities, including credit risk, liquidity risk, and the methods used to manage these risks. For instance, Deutsche Bank might disclose

that its maximum exposure to loss from the structured entity is \$500 million, which represents its investment in the entity. The bank might also provide details on how it mitigates these risks, such as through the use of credit enhancements, diversification of the underlying assets, and regular monitoring of the structured entity's performance.

Disclosure of Off-Balance-Sheet Exposures: In addition to direct interests in structured entities, Deutsche Bank might also be exposed to off-balance-sheet risks through guarantees, liquidity facilities, or derivative contracts related to the structured entities. IFRS 12 requires the bank to disclose these off-balance-sheet exposures, including the nature of the arrangements, the potential financial impact, and how these exposures are managed.

For example, Deutsche Bank might provide a liquidity facility to the structured entity, which could require the bank to provide additional funds in the event of a liquidity shortfall. The bank would disclose the terms of the liquidity facility, the potential maximum exposure, and the measures in place to mitigate this risk, such as collateral requirements or covenants that limit the entity's ability to draw on the facility.

7. 8. Measurement:

- i. **Measurement of Interests:** IFRS 12 does not provide specific guidance on the measurement of interests in other entities; instead, it refers to the measurement requirements in other standards such as IFRS 10 "Consolidated Financial Statements," IFRS 11 "Joint Arrangements," and IAS 28 "Investments in Associates and Joint Ventures." However, IFRS 12 requires entities to disclose how these interests are measured in the financial statements, including the methods used and any changes in measurement during the period.
- ii. **Consistency in Measurement:** Entities must ensure consistency in the measurement of interests in other entities across reporting periods. Any changes in measurement methods or assumptions must be disclosed, along with the impact of these changes on the financial statements.
- iii. **Practical Example - Retail Industry:** Consider Inditex, a Spanish multinational clothing company that owns brands such as Zara, Massimo Dutti, and Bershka. Inditex has various interests in subsidiaries, joint ventures, and associates, and the company must disclose how these interests are measured in its financial statements. For example, Inditex might

measure its investment in a joint venture in Asia at fair value, using a discounted cash flow (DCF) method to estimate the present value of expected future cash flows. The company would disclose the key assumptions used in the DCF model, such as the discount rate, growth rate, and terminal value. If Inditex changes its discount rate from 8% to 7% during the period, the company would disclose this change and its impact on the valuation of the joint venture.

- iv. **Impairment Testing:** In addition to measuring interests in other entities, IFRS 12 requires disclosures about any impairment testing performed on these interests. For example, if Inditex tests its investment in a subsidiary for impairment and determines that the carrying amount exceeds the recoverable amount, the company would disclose the impairment loss recognized, the method used to determine the recoverable amount, and the key assumptions underlying the impairment test.

7.9. Entity-Wide Disclosure:

- i. **Comprehensive Disclosure Requirements:** IFRS 12 requires entities to provide a comprehensive set of disclosures that cover all interests in other entities, including subsidiaries, joint arrangements, associates, and unconsolidated structured entities. These entity-wide disclosures are intended to provide users of financial statements with a holistic view of the entity's involvement in other entities and the associated risks and financial impacts.
- ii. **Disclosure of Risks and Uncertainties:** Entity-wide disclosures must include information about the risks and uncertainties associated with interests in other entities, including how these risks are managed and any changes in risk exposure during the period. This information helps users understand the potential impact of these risks on the entity's financial performance and position.
- iii. **Practical Example - Pharmaceuticals Industry:** Novartis AG, a Swiss multinational pharmaceutical company, has a wide range of interests in subsidiaries, joint ventures, and associates, as well as investments in unconsolidated structured entities. Novartis provides detailed entity-wide disclosures in its financial statements, covering all aspects of its involvement in other entities. For example, Novartis might disclose that it has a controlling interest in Sandoz, its generics division, as well as

significant investments in joint ventures focused on biotechnology research. The company would provide information about the risks associated with these interests, such as regulatory risks, patent expiration, and market competition. Novartis would also disclose how it manages these risks, such as through diversification of its product portfolio, investment in research and development, and strategic alliances with other pharmaceutical companies.

- iv. **Financial Impact and Reconciliation:** Novartis would provide a reconciliation of the carrying amounts of its interests in other entities to the amounts reported in the consolidated financial statements. This reconciliation would include details about any adjustments made during the period, such as the recognition of non-controlling interests, the equity method of accounting for associates, and the fair value measurement of investments in unconsolidated structured entities. For instance, Novartis might report a total carrying amount of CHF 10 billion for its interests in subsidiaries, joint ventures, and associates. The company would reconcile this amount to the consolidated financial statements, showing how the various components contribute to the overall financial position of the group.

7.10 Conclusion:

- i. **Comprehensive Understanding of IFRS 12:** IFRS 12 "Disclosure of Interests in Other Entities" plays a critical role in enhancing the transparency and comparability of financial statements. By requiring detailed disclosures about an entity's interests in subsidiaries, joint arrangements, associates, and unconsolidated structured entities, IFRS 12 ensures that users of financial statements have access to relevant information about the nature, risks, and financial impact of these interests.
- ii. **Real-Life Applications and Financial Impact:** The Practical Examples provided throughout this document illustrate how companies across various industries and jurisdictions apply IFRS 12 to disclose information about their interests in other entities. These examples demonstrate the practical application of the standard, highlighting the importance of transparent and comprehensive disclosures in understanding an entity's financial health and strategic direction.
- iii. **Future Considerations:** As companies continue to expand and diversify their operations, the application of IFRS 12 will remain critical in ensuring

that interests in other entities are reported transparently and consistently. Companies must continue to refine their disclosure practices to meet the expectations of stakeholders and comply with international financial reporting standard.

Summary of the Unit:

IFRS 12 enhances transparency by requiring entities to disclose their interests in subsidiaries, joint arrangements, associates, and structured entities. It applies to all entities that prepare consolidated financial statements or have significant interests in other entities. The standard ensures that financial statements provide relevant information about the risks and financial effects of these relationships. Key disclosure areas include control assessments, financial impacts of non-controlling interests, changes in ownership, and risks associated with unconsolidated structured entities. Entities must also disclose significant judgments made in determining control or influence over another entity. Real-world applications, such as Vodafone's joint ventures or Unilever's disclosures about Hindustan Unilever Limited, illustrate how IFRS 12 is applied in financial reporting. These disclosures provide a clearer picture of an entity's financial health and its strategic relationships with other entities. By improving transparency and comparability, IFRS 12 enhances investor confidence and supports better decision-making.

Short Questions:

1. What is the primary objective of IFRS 12?
2. What types of entities are required to apply IFRS 12?
3. Which key disclosure areas are covered under IFRS 12?
4. What significant judgments must entities disclose under IFRS 12?
5. How does IFRS 12 enhance transparency in financial reporting?
6. Why are non-controlling interests important in IFRS 12 disclosures?
7. What is the difference between joint control and significant influence?
8. Provide an example of a company that applies IFRS 12 in its financial reporting.
9. Why are structured entities an important aspect of IFRS 12?
10. What risks must be disclosed for unconsolidated structured entities?

Unit: 8

Fair Value Measurement

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UNIT 8: IFRS 13

Fair Value Measurement

Unit Introduction:

IFRS 13, "Fair Value Measurement," establishes a consistent framework for measuring fair value and requires comprehensive disclosures to enhance transparency in financial reporting. The standard applies to all IFRS standards that require fair value measurement, ensuring uniformity and comparability across industries and financial instruments. Fair value represents the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. IFRS 13 emphasizes a market-based approach rather than an entity-specific measurement, ensuring that valuations reflect real economic conditions. Entities must use appropriate valuation techniques, including the market, cost, and income approaches, and classify their fair value measurements into three levels under the fair value hierarchy. Companies like Nestlé and Deutsche Bank rely on IFRS 13 to measure their financial instruments, investment properties, and revalued assets accurately. By providing clear guidelines on fair value measurement, IFRS 13 enhances consistency, reduces subjectivity, and improves investor confidence in financial reporting.

OBJECTIVES

By the end of this unit, learners should be able to:

1. Explain the objective and scope of IFRS 13 in financial reporting.
2. Identify the valuation techniques and fair value hierarchy used in fair value measurement.
3. Analyze the importance of market-based measurements and their impact on financial statements.
4. Assess the disclosure requirements for fair value measurements, including recurring and non-recurring measurements.
5. Interpret real-world applications of IFRS 13 through case studies and financial disclosures.

8.1. Objective of Fair Value Measurement:

- i. **Core Objective:** The primary objective of the Fair Value Measurement standard (IFRS 13) is to provide a framework for measuring fair value and to require disclosures about fair value measurements. Fair value represents 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.
- ii. **Consistency and Comparability:** IFRS 13 aims to ensure consistency and comparability in fair value measurements across entities and transactions. By providing a single framework for measuring fair value, the standard helps eliminate inconsistencies that may arise when different standards provide varying guidance on fair value.
- iii. **Market-Based Measurement:** Fair value is a market-based measurement, not an entity-specific measurement. This means that fair value should be determined based on the assumptions that market participants would use when pricing the asset or liability, rather than the assumptions specific to the entity holding the asset or liability.
- iv. **Practical Example:** Consider a multinational corporation, such as Nestlé, that holds a portfolio of financial assets, including equity investments in publicly traded companies. The objective of IFRS 13 ensures that Nestlé measures these equity investments at fair value based on observable market prices at the measurement date, providing a consistent and comparable measure of value across its portfolio. For example, if Nestlé holds 100,000 shares in Company X, and the market price of each share on the measurement date is CHF 50, the fair value of the equity investment would be CHF 5,000,000 (100,000 shares * CHF 50 per share).

8.2. Scope of Fair Value Measurement:

IFRS 13 applies to all IFRS standards that require or permit fair value measurements or disclosures. The standard covers both recurring fair value measurements (such as those required at each reporting period) and non-recurring measurements (such as those required in specific circumstances, like impairment testing). IFRS 13 is applied in measuring fair value under various standards, including:

- i. IFRS 9 "Financial Instruments" for the measurement of financial assets and liabilities.

- ii. IAS 16 "Property, Plant, and Equipment" for revaluation of property, plant, and equipment.
- iii. IAS 40 "Investment Property" for measuring investment property at fair value.
- iv. IFRS 3 "Business Combinations" for measuring assets acquired and liabilities assumed in a business combination.

Exclusions from Scope: Certain measurements are outside the scope of IFRS 13, including:

- i. Share-based payment transactions under IFRS 2.
- ii. Lease transactions under IFRS 16.
- iii. Measurements that are similar to fair value but are not considered fair value, such as net realizable value under IAS 2 "Inventories."

Practical Example: Suppose Vodafone Group Plc, a multinational telecommunications company, is involved in various transactions that require fair value measurement. Vodafone applies IFRS 13 to measure the fair value of its investment properties under IAS 40, its financial instruments under IFRS 9, and assets acquired in a business combination under IFRS 3. However, Vodafone does not apply IFRS 13 to its share-based payment transactions, which are covered by IFRS 2. For instance, Vodafone might hold an investment property in London with a fair value of £200 million, determined using market comparable under IFRS 13. This measurement reflects the price that would be received in an orderly transaction between market participants at the measurement date.

8.3. Measurement of Fair Value:

Fair Value Definition: Fair value is defined as 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. The fair value measurement should consider the following:

- i. The asset or liability being measured.
- ii. The market in which the transaction would take place.
- iii. The highest and best use of a non-financial asset.

Valuation Techniques: IFRS 13 outlines three primary valuation techniques for measuring fair value:

- i. **Market Approach:** Uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

- ii. **Cost Approach:** Reflects the amount that would be required to replace the service capacity of an asset (current replacement cost).
- iii. **Income Approach:** Converts future amounts (cash flows or income and expenses) to a single current (discounted) amount.

Entities should use valuation techniques consistent with one or more of these approaches, selecting the most appropriate technique for the specific asset or liability being measured.

Fair Value Hierarchy: IFRS 13 establishes a fair value hierarchy that categorizes the inputs used in valuation techniques into three levels:

- i. **Level 1:** Quoted prices (unadjusted) in active markets for identical assets or liabilities.
- ii. **Level 2:** Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.
- iii. **Level 3:** Unobservable inputs for the asset or liability, used when observable inputs are not available.

Practical Example: Consider the case of Deutsche Bank, a German multinational investment bank, which holds a portfolio of financial derivatives. The fair value of these derivatives is measured using different valuation techniques depending on the type of instrument and the availability of observable inputs. For example, Deutsche Bank might use the market approach to value exchange-traded derivatives (Level 1) by referring to the quoted market prices. For over-the-counter (OTC) derivatives, such as interest rate swaps, Deutsche Bank might use the income approach (Level 2) by discounting future cash flows using observable market interest rates.

In situations where market data is not available, Deutsche Bank might rely on internal models and unobservable inputs (Level 3) to estimate the fair value of complex or illiquid derivatives. For instance, if Deutsche Bank holds a structured credit derivative that is thinly traded, the bank might use a model-based valuation with assumptions about credit spreads, default probabilities, and recovery rates, categorized as Level 3 inputs.

8.4. Disclosure Requirements:

Disclosure Objectives: The disclosure requirements of IFRS 13 are designed to help users of financial statements understand the valuation techniques and inputs used in fair value measurements and assess the impact of those measurements on the entity's financial position and performance.

Key Disclosure Requirements: Entities are required to disclose the following information:

- i. **Fair Value Measurement on a Recurring Basis:** Information about the fair value measurements at the end of the reporting period, including the level of the fair value hierarchy and the valuation techniques used.
- ii. **Non-Recurring Fair Value Measurement:** Disclosures for assets and liabilities measured at fair value on a non-recurring basis, such as when an asset is impaired.
- iii. **Level 3 Reconciliation:** A reconciliation of the beginning and ending balances for recurring fair value measurements categorized within Level 3 of the fair value hierarchy.
- iv. **Sensitivity Analysis:** For fair value measurements categorized within Level 3, entities must disclose the sensitivity of the fair value measurement to changes in unobservable inputs.

Practical Example: Assume that Rolls-Royce Holdings, a British multinational aerospace and defence company, holds a portfolio of assets that includes property, plant, and equipment revalued at fair value, investment properties, and financial instruments measured at fair value.

Fair Value Measurement on a Recurring Basis: Rolls-Royce might disclose that its investment properties are measured at fair value using the market approach, with valuations categorized as Level 2. The company could provide additional details, such as the use of market comparable for similar properties in the same geographic area.

Level 3 Reconciliation: Suppose Rolls-Royce also holds complex financial instruments, such as unlisted equity investments in aerospace technology startups. The fair value of these investments might be categorized as Level 3 due to the use of unobservable inputs. Rolls-Royce would provide a reconciliation of the beginning and ending balances of these investments, including any changes resulting from purchases, sales, gains or losses recognized in profit or loss, and any transfers into or out of Level 3. For example, if Rolls-Royce began the year with a Level 3 investment valued at £10 million and recognized a fair value gain of £2 million during the year, the ending balance would be £12 million. Rolls-Royce would disclose the significant unobservable inputs used in the valuation, such as expected growth rates, discount rates, and marketability discounts.

Sensitivity Analysis: Rolls-Royce might also disclose a sensitivity analysis for its Level 3 investments, indicating that a 1% increase in the discount rate would result

in a £500,000 decrease in fair value, while a 1% decrease in the discount rate would result in a £600,000 increase in fair value.

8. 5. Real-Life Case Studies:

- i. **Case Study 1: Investment Property Valuation - Unilever** Unilever, a British-Dutch multinational consumer goods company, holds investment properties that are measured at fair value under IAS 40 and disclosed according to IFRS 13. In one of its financial reports, Unilever may disclose that it owns an office building in London valued at £50 million. The valuation is based on a market approach, with comparable sales of similar properties in the area serving as the primary inputs. Unilever would categorize the valuation as Level 2 in the fair value hierarchy and provide information about the significant inputs used, such as the price per square foot, adjustments for property location, and market trends.
- ii. **Case Study 2: Financial Instruments - HSBC Holdings** HSBC Holdings, one of the largest banking and financial services organizations in the world, uses IFRS 13 to measure the fair value of its extensive portfolio of financial instruments. For example, HSBC might disclose that it holds £500 million in government bonds, categorized as Level 1 due to the availability of quoted prices in active markets. Additionally, HSBC might hold £200 million in corporate bonds, categorized as Level 2, where fair value is determined using observable inputs such as credit spreads and yield curves. HSBC would provide a breakdown of its Level 3 financial instruments, such as complex derivatives or structured products, including a sensitivity analysis showing how changes in key assumptions impact fair value.
- iii. **Case Study 3: Revaluation of Plant and Equipment - Tata Steel** Tata Steel, a global steel manufacturing company based in India, applies IFRS 13 to measure the fair value of its plant and equipment under IAS 16. Tata Steel may conduct a revaluation of its steel plants, resulting in an increase in carrying value from \$50 billion to \$60 billion. The revaluation is based on the cost approach, considering the current replacement cost of the plants and adjusted for any obsolescence. Tata Steel would disclose that the fair value measurement is categorized as Level 2 and provide details on the assumptions used, such as the cost of new construction, technology upgrades, and inflation rates.

8.6. Challenges and Best Practices in Fair Value Measurement

Challenges in Fair Value Measurement:

- i. **Valuation of Illiquid Assets:** Measuring the fair value of assets that do not have an active market, such as private equity investments or specialized equipment, can be challenging. Entities must rely on internal models and unobservable inputs, which can introduce subjectivity and increase the risk of misstatement.
- ii. **Impact of Market Volatility:** In times of market volatility, the fair value of assets and liabilities can fluctuate significantly, leading to challenges in determining an appropriate measurement date and capturing the fair value accurately.
- iii. **Regulatory and Compliance Issues:** Ensuring compliance with IFRS 13 and local regulatory requirements can be complex, particularly for multinational corporations with diverse asset portfolios spread across different jurisdictions.

Best Practices in Fair Value Measurement:

- i. **Use of Multiple Valuation Techniques:** Where possible, entities should use more than one valuation technique to corroborate the fair value measurement. This approach helps to reduce the reliance on a single model and provides greater confidence in the results.
- ii. **Regular Calibration of Models:** Entities should regularly calibrate their valuation models using recent transaction data or observable market inputs. This practice ensures that the models remain accurate and reflective of current market conditions.
- iii. **Enhanced Disclosure and Transparency:** Providing detailed disclosures about the valuation techniques, inputs, and assumptions used in fair value measurements is critical to maintaining transparency and building trust with stakeholders. Entities should also provide sensitivity analyses to help users understand the potential impact of changes in key assumptions.

8.7 Conclusion:

- i. **Comprehensive Understanding of Fair Value Measurement:** The Fair Value Measurement standard (IFRS 13) plays a crucial role in ensuring the consistency, transparency, and comparability of financial statements across different entities and industries. By providing a clear framework for

measuring fair value, IFRS 13 helps entities present a true and fair view of their financial position and performance.

- ii. **Real-Life Applications and Financial Impact:** The Practical Examples and case studies discussed in this document illustrate how multinational corporations apply IFRS 13 to measure and disclose the fair value of their assets and liabilities. These examples demonstrate the practical challenges and best practices in fair value measurement, highlighting the importance of using appropriate valuation techniques, calibrating models, and providing comprehensive disclosures.
- iii. **Future Considerations:** As global markets continue to evolve, the application of IFRS 13 will remain critical in ensuring that financial statements reflect the true economic value of assets and liabilities. Entities must stay vigilant in adapting their fair value measurement practices to changing market conditions, new regulatory requirements, and advances in valuation methodologies.

Unit Summary: Fair Value Measurement (IFRS 13)

Fair Value Measurement (IFRS 13) provides a standardized framework for determining fair value across various financial reporting scenarios. The core objective of IFRS 13 is to ensure consistency and comparability in fair value measurements, using market-based rather than entity-specific assumptions. It applies to both recurring (periodic) and non-recurring (event-driven) fair value measurements across different IFRS standards, such as IFRS 9 (Financial Instruments), IAS 16 (Property, Plant, and Equipment), and IFRS 3 (Business Combinations). However, IFRS 13 excludes share-based payments (IFRS 2) and lease transactions (IFRS 16).

The measurement of fair value under IFRS 13 considers the highest and best use of non-financial assets and the principal or most advantageous market. It relies on three primary valuation techniques: the market approach (based on comparable transactions), the cost approach (replacement cost method), and the income approach (discounted cash flow model). To ensure accuracy, IFRS 13 introduces a fair value hierarchy with three levels: Level 1 (quoted market prices), Level 2 (observable inputs like yield curves), and Level 3 (unobservable inputs requiring estimation models).

Test Questions:

1. What is the primary objective of IFRS 13 regarding fair value measurement?
2. How does IFRS 13 ensure consistency and comparability in fair value reporting?
3. What are the three main valuation techniques used in fair value measurement?
4. Define the three levels of the fair value hierarchy under IFRS 13.
5. Give an example of a financial instrument that would fall under Level 1, Level 2, and Level 3 measurements.
6. Which IFRS standards require fair value measurement under IFRS 13, and which are excluded?
7. Why is the highest and best use concept important in fair value measurement?
8. What are the key disclosure requirements for fair value measurement under IFRS 13?
9. What are the main challenges entities face when measuring fair value under IFRS 13?
10. How can an entity enhance transparency and accuracy in fair value reporting?

Unit: 9

Revenue from Contracts with Customers

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UNIT 9: IFRS 15

Revenue from Contracts with Customers

Unit Introduction:

Revenue is one of the most critical financial metrics in any business, directly influencing profitability, performance evaluation, and decision-making by investors and stakeholders. IFRS 15, *Revenue from Contracts with Customers*, was introduced to provide a unified framework for revenue recognition across industries and transactions. It replaces previous standards, such as IAS 18 *Revenue* and IAS 11 *Construction Contracts*, which had inconsistencies in their application. The core principle of IFRS 15 is that revenue should be recognized in a way that reflects the transfer of goods or services to customers at an amount the entity expects to receive. This ensures that financial statements present a true and fair view of an entity's economic activities. IFRS 15 introduces a five-step revenue recognition model that applies to all industries, ensuring consistency and transparency in financial reporting. By implementing IFRS 15, companies can provide investors and stakeholders with clearer insights into the timing, nature, and uncertainty of revenue and cash flows. The standard also enhances comparability between entities, allowing financial statement users to better assess performance across different industries and markets. Understanding and applying IFRS 15 is crucial for accountants, auditors, financial analysts, and corporate decision-makers.

OBJECTIVES

By the end of this unit, learners should be able to:

1. Explain the core objective and scope of IFRS 15.
2. Identify the five-step revenue recognition model under IFRS 15.
3. Understand how revenue is measured, including variable consideration and financing components.
4. Describe the presentation and disclosure requirements for revenue contracts.
5. Analyze real-world applications of IFRS 15 in different industries.

9.1. Objective of IFRS 15

- i. **Core Objective:** The primary objective of IFRS 15 is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The core principle is that an entity should recognize revenue in a way that reflects the transfer of 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.
- ii. **Revenue Recognition Model:** IFRS 15 introduces a comprehensive model for recognizing revenue, based on the contract between an entity and its customer. The model ensures that revenue is recognized in a manner that depicts the pattern of transfer of control of goods or services to the customer, rather than simply focusing on the transfer of risks and rewards.
- iii. **Practical Example:** Consider a telecommunications company, such as Vodafone Group Plc, that offers bundled services, including mobile phone sales, network access, and data services. Under IFRS 15, Vodafone recognizes revenue in a way that reflects the transfer of each component of the bundled services. For example, revenue from the sale of the mobile phone is recognized at the point of transfer of control, while revenue from network access and data services is recognized over time as the services are provided. If Vodafone sells a mobile phone for £300 and provides a 12-month network service contract at £20 per month, it must allocate the transaction price (£540 in total) between the mobile phone and the service contract based on their relative standalone selling prices. If the standalone selling price of the mobile phone is £250 and the service contract is £25 per month, Vodafone would recognize £250 as revenue upon the sale of the phone and £25 per month for the network services.

9.2. Scope of IFRS 15:

Entities and Contracts Covered: IFRS 15 applies to all contracts with customers, except for the following, which are covered by other standards:

- i. Lease contracts (IFRS 16).
- ii. Insurance contracts (IFRS 4 and IFRS 17).
- iii. Financial instruments and other contractual rights or obligations (IFRS 9, IFRS 10, IFRS 11, IAS 27, and IAS 28).

- iv. Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

Contracts Excluded: Contracts that are not with customers, such as those with partners or collaborators that share in the risks and benefits of a joint operation, are excluded from the scope of IFRS 15. Additionally, contracts that result in financial instruments, leases, insurance contracts, or guarantees are outside the scope of IFRS

Practical Example - Pharmaceutical Industry: GlaxoSmithKline (GSK), a British multinational pharmaceutical company, enters into various contracts for the sale of pharmaceuticals and healthcare products. These contracts fall within the scope of IFRS 15. However, GSK also enters into licensing agreements and research collaborations that may be scoped out of IFRS 15, depending on the nature of the agreement. For example, if GSK licenses a patent to another company and retains significant ongoing involvement in the development of the drug, the contract might be outside the scope of IFRS 15 and instead fall under IFRS 10 or IAS 28.

9.3. Recognition of Revenue under IFRS 15

Five-Step Model for Revenue Recognition: IFRS 15 introduces a five-step model for recognizing revenue, which is applicable to all contracts with customers:

- i. **Identify the Contract with a Customer:** A contract is an agreement between two or more parties that creates enforceable rights and obligations. The contract must meet specific criteria, including the approval and commitment of the parties, identification of payment terms, and commercial substance.
- ii. **Identify the Performance Obligations:** A performance obligation is a promise in a contract to transfer a distinct good or service to the customer. A good or service is distinct if the customer can benefit from it on its own or together with other readily available resources.
- iii. **Determine the Transaction Price:** The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price may include fixed amounts, variable consideration, and any non-cash consideration.
- iv. **Allocate the Transaction Price:** If a contract has multiple performance obligations, the entity must allocate the transaction price to each

performance obligation based on the relative standalone selling prices of the goods or services.

- v. **Recognize Revenue:** Revenue is recognized when (or as) the entity satisfies a performance obligation by transferring control of a good or service to the customer.

Practical Example - Technology Industry: Apple Inc., a multinational technology company, provides a clear example of how the five-step model is applied under IFRS 15. Suppose Apple enters into a contract to sell a customer an iPhone bundled with a 24-month service plan for a total transaction price of \$1,200.

- i. **Identify the Contract:** The contract is approved by both Apple and the customer, with clear payment terms and commercial substance.
- ii. **Identify the Performance Obligations:** The contract has two performance obligations: the sale of the iPhone and the provision of the 24-month service plan.
- iii. **Determine the Transaction Price:** The total transaction price is \$1,200.
- iv. **Allocate the Transaction Price:** The standalone selling price of the iPhone is \$700, and the standalone selling price of the service plan is \$600 (\$25 per month). The transaction price is allocated proportionally based on these standalone prices.
- v. **Recognize Revenue:** Apple recognizes \$672 as revenue when the iPhone is delivered to the customer and recognizes \$22 per month (\$528/24 months) as revenue for the service plan.

9.4. Measurement of Revenue:

Determining the Transaction Price: The transaction price is the total amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to the customer. When determining the transaction price, entities must consider several factors, including:

- i. **Variable Consideration:** If the consideration in a contract is variable, such as discounts, rebates, or performance bonuses, the entity must estimate the amount of variable consideration it expects to receive. This estimation must

reflect the probability-weighted amount or the most likely amount, depending on which method better predicts the amount of consideration.

- ii. **Significant Financing Component:** If a contract includes a significant financing component, the entity must adjust the promised amount of consideration to reflect the time value of money.
- iii. **Non-Cash Consideration:** If the customer provides non-cash consideration, such as goods or services, the entity must measure the non-cash consideration at fair value.

Practical Example - Construction Industry: Consider a construction company, Vinci S.A., which enters into a contract to build a commercial building for a customer. The contract price is €50 million, with a potential bonus of €5 million if the project is completed within 18 months.

- i. **Variable Consideration:** Vinci must estimate the likelihood of earning the bonus based on historical performance and the specific conditions of the contract. If Vinci estimates a 60% probability of earning the bonus, the expected value of the variable consideration is: The transaction price, therefore, is €53 million (€50 million fixed + €3 million expected bonus).
- ii. **Significant Financing Component:** If the contract includes deferred payments, Vinci must consider whether the time value of money is significant. For example, if the payment is deferred for three years, Vinci might need to discount the transaction price to present value using an appropriate discount rate.
- iii. **Revenue Recognition:** Vinci recognizes revenue over time as it satisfies its performance obligations, typically using a percentage of completion method. If Vinci has completed 40% of the work by the end of the first year, it would recognize €21.2 million as revenue (40% of €53 million).

9.5. Contract Costs:

Types of Contract Costs: IFRS 15 specifies the accounting treatment for costs incurred in fulfilling a contract with a customer. These costs are categorized as:

- i. **Incremental Costs of Obtaining a Contract:** Costs that an entity incurs to obtain a contract that it would not have incurred if the contract had not been

obtained (e.g., sales commissions). These costs are capitalized and amortized over the period of the contract.

- ii. **Costs to Fulfill a Contract:** Costs that relate directly to a contract and generate or enhance resources that will be used to satisfy performance obligations. These costs are capitalized if they meet specific criteria and amortized on a systematic basis consistent with the transfer of the related goods or services.

Practical Example - Software Industry: SAP SE, a German multinational software corporation, incurs costs to obtain and fulfill contracts with customers for its enterprise software solutions. Suppose SAP incurs €1 million in sales commissions for obtaining a multi-year software licensing contract.

- i. **Incremental Costs of Obtaining a Contract:** The €1 million in sales commissions is capitalized as a contract asset, as SAP would not have incurred this cost if it had not obtained the contract.
- ii. **Costs to Fulfill a Contract:** SAP might also incur costs related to setting up and configuring the software for the customer, amounting to €2 million. These costs are capitalized if they meet the criteria (i.e., they generate or enhance resources that will be used to satisfy performance obligations).
- iii. **Amortization of Contract Costs:** SAP amortizes the €3 million (€1 million for sales commissions + €2 million for setup costs) over the contract period, which might be five years. If the contract is for five years, SAP would amortize €600,000 annually.

9.6. Presentation:

Presentation in Financial Statements: IFRS 15 requires entities to present contract assets, contract liabilities, and receivables separately in the statement of financial position. The standard also provides guidance on the presentation of revenue, contract costs, and other related items in the statement of profit or loss and other comprehensive income.

Contract Assets and Liabilities:

- i. **Contract Assets:** A contract asset is recognized when an entity has transferred goods or services to a customer but is yet to have an unconditional right to receive payment. It represents the entity's right to

consideration in exchange for goods or services that have been transferred but not yet billed.

- ii. **Contract Liabilities:** A contract liability is recognized when a customer has paid consideration or when the entity has a right to an amount of consideration that is unconditional before the entity has transferred the goods or services to the customer. It represents the entity's obligation to transfer goods or services to the customer.

Practical Example - Aerospace Industry: Airbus SE, a European multinational aerospace corporation, manufactures and sells aircraft to airlines under long-term contracts. Suppose Airbus enters into a contract to sell 10 aircraft for €1 billion, with the customer paying a deposit of €200 million upon signing the contract.

- i. **Contract Liability:** The €200 million deposit is recognized as a contract liability, as Airbus has received payment but has not yet delivered the aircraft. This amount remains a liability until Airbus transfers control of the aircraft to the customer.
- ii. **Contract Asset:** As Airbus progresses with the manufacturing of the aircraft, it recognizes revenue based on the percentage of completion. If Airbus has completed 50% of the work by the end of the first year, it recognizes €500 million in revenue. If Airbus has not yet billed the customer for this work, it recognizes a contract asset for the amount due.
- iii. **Presentation:** In its financial statements, Airbus presents the €200 million contract liability and the €500 million contract asset separately on the balance sheet. Revenue from the sale of aircraft is presented in the statement of profit or loss as the performance obligations are satisfied.

7. Disclosure:

Comprehensive Disclosure Requirements: IFRS 15 requires entities to provide detailed disclosures that help users of financial statements understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The disclosure requirements include:

- i. **Disaggregation of Revenue:** Entities must disaggregate revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors (e.g., by product line, geographical region, or contract type).

- ii. **Contract Balances:** Entities must disclose the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers, along with an explanation of significant changes during the period.
- iii. **Performance Obligations:** Entities must disclose information about their performance obligations, including when they typically satisfy these obligations, the significant payment terms, and the nature of the goods or services promised.
- iv. **Transaction Price Allocated to Remaining Performance Obligations:** Entities must disclose the amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the end of the reporting period and when they expect to recognize that amount as revenue.

Practical Example - Automotive Industry: BMW AG, a German multinational automotive manufacturer, discloses detailed information about its revenue from contracts with customers in its financial statements. Suppose BMW generates revenue from the sale of vehicles, parts, and maintenance services.

- i. **Disaggregation of Revenue:** BMW disaggregates revenue by product line (vehicles, parts, services) and by geographical region (Europe, Asia, Americas). For example, BMW might report €80 billion in vehicle sales, €10 billion in parts sales, and €5 billion in service revenue, with €50 billion generated in Europe, €30 billion in Asia, and €15 billion in the Americas.
- ii. **Contract Balances:** BMW discloses the opening and closing balances of contract liabilities related to advance payments received from customers for vehicle orders. If BMW had €1 billion in contract liabilities at the beginning of the year and €1.2 billion at the end of the year, the company explains the reasons for the increase, such as higher customer deposits on new vehicle orders.
- iii. **Performance Obligations:** BMW provides information about its performance obligations related to vehicle sales, including the timing of revenue recognition (at the point of delivery) and the typical payment terms (e.g., payment due upon delivery or within 30 days).

- iv. **Transaction Price Allocated to Remaining Performance Obligations:** BMW discloses the amount of transaction price allocated to performance obligations that remain unsatisfied at the end of the reporting period, such as ongoing maintenance service contracts. For example, BMW might disclose that €500 million in revenue is expected to be recognized over the next three years as the company provides maintenance services to customers.

9.7 Conclusion:

- i. **Comprehensive Understanding of IFRS 15:** IFRS 15 "Revenue from Contracts with Customers" provides a robust framework for recognizing and measuring revenue in a way that reflects the transfer of goods or services to customers. The standard's five-step model ensures that revenue recognition aligns with the timing of performance obligations and the transfer of control, providing a clear and consistent approach across different industries and transactions.
- ii. **Real-Life Applications and Financial Impact:** The Practical Examples provided throughout this document illustrate how companies across various industries apply IFRS 15 to recognize, measure, present, and disclose revenue from contracts with customers. These examples demonstrate the practical application of the standard, highlighting the importance of understanding contract terms, performance obligations, and the impact of variable consideration and financing components.
- iii. **Future Considerations:** As businesses continue to evolve and enter into increasingly complex contracts with customers, the application of IFRS 15 will remain critical in ensuring that revenue is recognized accurately and transparently. Companies must continue to refine their revenue recognition practices to meet the expectations of stakeholders and comply with international financial reporting standards.

Unit Summary

Revenue is a key financial metric that impacts business profitability, stakeholder decision-making, and financial performance evaluation. IFRS 15: Revenue from Contracts with Customers was introduced to provide a unified framework for revenue recognition across industries, replacing IAS 18 (Revenue) and IAS 11 (Construction Contracts). The standard ensures that revenue is recognized in a way

that reflects the transfer of goods or services to customers at an amount that the entity expects to receive. IFRS 15 enhances transparency and comparability in financial reporting by applying a five-step revenue recognition model, which helps businesses structure their revenue recognition processes consistently.

The scope of IFRS 15 covers all contracts with customers, except for lease contracts (IFRS 16), insurance contracts (IFRS 17), and financial instruments (IFRS 9). Revenue is recognized when an entity transfers control of a good or service to the customer, rather than when risks and rewards are transferred. The five-step model consists of: (1) Identifying the contract, (2) Identifying performance obligations, (3) Determining the transaction price, (4) Allocating the transaction price, and (5) Recognizing revenue. This model ensures that revenue is recorded systematically and reflects the true economic activity of an entity.

Revenue measurement under IFRS 15 considers variable consideration, financing components, and non-cash consideration. Entities must estimate the expected amount of variable consideration and assess whether a significant financing component exists. Contract costs, such as incremental costs of obtaining a contract and costs to fulfill a contract, must also be accounted for. Companies in various industries, such as technology (Apple), telecommunications (Vodafone), and construction (Vinci S.A.), apply IFRS 15 to allocate transaction prices correctly and recognize revenue based on contract performance obligations.

Test Questions:

1. What is the main objective of IFRS 15 in revenue recognition?
2. How does IFRS 15 improve comparability in financial reporting?
3. What are the five steps in the revenue recognition model under IFRS 15?
4. Which types of contracts are excluded from the scope of IFRS 15?
5. How does IFRS 15 define the "transfer of control" in revenue recognition?
6. What are the key factors to consider when determining the transaction price under IFRS 15?
7. How should an entity allocate the transaction price if a contract contains multiple performance obligations?
8. What is "variable consideration," and how does IFRS 15 address it?
9. What are contract assets and contract liabilities, and how should they be presented in financial statements?
10. How do companies in industries such as telecommunications and technology apply IFRS 15 in revenue recognition?

Summary of IFRS 15

IFRS 15 establishes a structured approach to revenue recognition through a five-step model. First, an entity must identify the contract with a customer, ensuring that it meets the criteria for enforceability. Second, the entity must identify the performance obligations within the contract—these are the goods or services that must be transferred to the customer. Third, the entity must determine the transaction price, which includes fixed amounts, variable consideration, and adjustments for financing components. Fourth, the transaction price must be allocated to the identified performance obligations based on their standalone selling prices. Finally, revenue is recognized when the performance obligations are satisfied, meaning control of the goods or services has been transferred to the customer.

The standard applies to all contracts with customers except those covered under IFRS 16 (leases), IFRS 4 and IFRS 17 (insurance contracts), and IFRS 9 (financial instruments). IFRS 15 also addresses contract costs, requiring entities to capitalize certain costs directly related to obtaining or fulfilling a contract and amortize them systematically over time. Entities must disclose detailed information about contract balances, performance obligations, and the allocation of transaction prices. This ensures transparency in financial reporting and allows users of financial statements to assess the financial health of an organization accurately. Industries such as telecommunications, construction, and software services often enter into complex contracts, and IFRS 15 provides clear guidelines for recognizing revenue in such scenarios.

Test Questions for IFRS 15

1. What is the core objective of IFRS 15?
2. What are the five steps in the revenue recognition model under IFRS 15?
3. How does IFRS 15 define a performance obligation?
4. When should revenue be recognized under IFRS 15?
5. How does IFRS 15 treat variable consideration in determining the transaction price?
6. What is the difference between contract assets and contract liabilities?
7. Provide an example of how IFRS 15 applies to bundled services.
8. What are the key disclosure requirements under IFRS 15?
9. How is revenue from long-term construction contracts recognized under IFRS 15?
10. How does IFRS 15 improve transparency and comparability in financial reporting?