IFRS accounting choices: an impediment to comparability?

Objective

1 The objective of this session is to obtain input from CMAC members as to whether they believe IFRS allows too many accounting choices for preparers of financial statements and whether steps should be taken to reduce the number of accounting choices in the future.

Background

2 The ability to compare the financial performance and position of peer companies is critical for analysts, investors, and other users of financial statements.

3 The Conceptual Framework (2010) states that "the usefulness of financial information is enhanced if it is comparable…" (QC5) and recognizes that "…permitting alternative accounting methods for the same economic phenomenon diminishes comparability" (QC 25).

4 However several accounting choices exist under IFRS and can create hurdles for analysis while adding little valuable information.

5 Some accounting choices may be warranted as they allow companies to "tell their story" and treat transactions in a manner appropriate to their business models. But often, different companies report identical transactions differently, with no apparent justification.

6 Many of these needless accounting choices are presentational in nature and could easily be eliminated.

Example

7 U.S. GAAP, companies have to classify their cash interest paid and received (as well as dividends received) as part of operating cash flows. Unfortunately, under IFRS there is no such uniform reporting. International Accounting Standard (IAS) 7, Statement of Cash Flows, allows companies to classify interest paid as either operating or financing cash flows, and to classify interest and dividends received as either operating or investing cash flows. Therefore, to compare two companies' operating cash flows on a like-for-like manner, analysts must make adjustments.

8 An unsophisticated reader of financial statements might miss this point and reach the wrong conclusion about a company's ability to generate future cash flows relative to its peers.

9 Two companies in the telecom sector--Deutsche Telekom AG and Vodafone AG--illustrate the point (see table 1 below). If Vodafone's cash interest and dividends received are reclassified as operating cash flows to mirror Deutsche Telekom's reporting, Vodafone's operating cash flows increase by £3.6 billion, or 58%.

Table 1

Differing Approaches To Presentation Of Cash Interest And Dividends Received						
--Deutsche Telecom, presenting items as operating cash flows--		--Vodadone, presenting items as investing or financing--				
	2013 (mil. €)		2014 (mil. £)	Reclassify*	Adjusted	Increase (%)
Dividends received	273	**Net cash flow from operating activities**	**6,227**	**3,592**	**9,819**	**58**
Cash generated from operations	**15,092**	Dividends received from associates and joint ventures*	4,897	--	--	--
Interest paid	(2,961)	Dividends received from investments*	10	--	--	--
Interest received	886	Interest received*	582	--	--	--
Net cash from operating activities	**13,017**	**Net cash flow from investing activities**	**30,743**	--	--	--
		Interest paid*	(1,897)	--	--	--
		Net cash flow from financing activities	**(34,249)**	--	--	--

*Extracted from the cash flow statement.

Question for CMAC members

10 Do CMAC members believe that the accounting choice to present interest and dividend received cash flows in different cash flow categories is unhelpful and do they prefer the uniformity of US GAAP reporting, where this is always presented as an operating cash flow?

Other examples

11 There are plenty of similar accounting options under IFRS that can impede comparability. At S&P Global ratings, to the extent possible, using the methodology detailed in the fourth column of table 2 below, we make adjustments to the reported financial statements of companies that chose the approach in the third column. Our goal is to create a view of their financials that is comparable to our preferred approach, in column two.

Table 2 – How S&P Global Ratings addresses certain accounting choices available to corporates

Accounting choice	S&P preferred choice	Alternative choice	S&P methodology	Easy to eliminate?
Income statement presentation of gains/losses on sale of businesses, PPE and intangible assets	Below operating profit*	Part of operating profit	In calculating our adjusted measures such as EBITDA and funds from operations, we view gains/losses on the sale of businesses, PPE and intangible assets as non-operating items and remove them from operating profit if they are reported as such.	Yes
Classification of pension interest in income statement	Classified as an interest expense	Classified as an operating expense	We include pension interest expense within our adjusted interest expense metric. If pension interest is classified as an operating expense, we make an adjustment to add that amount back to operating profit and EBITDA.	Yes
Treatment of hedging derivatives in the income statement	Hedge accounting - so the financial statements reflect the economically hedged arrangement	No hedge accounting, with the derivative marked-to-market and the change in fair value hitting the	Where we have sufficient information, we exclude any unrealized fair gains/losses on derivatives not related to current-year activity, so that the income statement represents the economic hedge position achieved in the current year (that is, as if hedge accounting had been used).	No

		income statement each period		
Preparation of a direct or indirect cash flow statement	Indirect cash flow statement	Direct cash flow statement	We have no specific methodology, but we prefer the indirect cash flow statement (which bridges the income statement to the cash flow statement) because it includes useful information about non-cash reconciling items and working-capital movements.	No
Treatment of discontinued operations in cash flow statement	Present only continuing cash flows in main body of cash flow statement with discontinued cash flows disclosed separately (similar to requirement for income statement)	Present cash flows from entire business in main body of cash flow statement	Where material and practical we seek to exclude discontinued cash flows from our metrics so that they more accurately reflect the company's ongoing operations	Yes
Measurement of debt on the balance sheet	Amortized cost	Fair value option	Where companies report debt at fair value rather than at amortized cost, we adjusted the reported figure to reflect the amortized cost amount. If the amortized cost figure is not shown in the financial statements, we may estimate it, based on the amount originally received or the face value plus accrued but unpaid interest.	Yes
Classification of accrued interest on the balance sheet	Included in reported debt	Excluded in reported debt	We reclassify as debt any accrued interest that is not already included in reported debt	Yes

*These presentational options arise because operating profit, while commonly disclosed by companies, is not an IFRS-defined measure

Questions for CMAC members

12 Would CMAC members like any of the above accounting choices eliminated? If so, which ones and why?

13 Are there any other accounting choices that members are aware of that can cause comparability issues?

Recent decisions taken by IASB suggest standardizing accounting is not a priority

14 Accounting boards have passed up recent opportunities to standardize reporting options, suggesting that this may not be a priority.

15 The revisions to IAS 19 Employee Benefits, effective in 2013, were an opportunity for the IASB to fix a long-standing complaint about the IFRS approach to accounting for pension interest in the income statement. Under the old version of IAS 19, companies were able to classify the interest relating to pensions as either a finance cost (which S&P believes is the appropriate classification) or as an operating expense.

16 The exposure draft for the revised version of IAS 19 contained the following encouraging proposal: "An entity shall present net interest on the net defined benefit liability (asset) as part of finance costs in profit or loss."

17 When the final revised version of IAS 19 Employee Benefits was published, however, the Board had backtracked on that proposal, so that the guidance reverted to the old approach--which does not specify how pension interest should be presented. The IASB explained the rationale for not requiring this to be shown as a financing item in the basis of conclusions appendix to the final accounting standard. The complication was that one seemingly isolated change could have important ramifications elsewhere. The Board would also have needed to consider in due course whether it should apply similar treatment to amounts related to the passage of time in other projects, such as revenue recognition, insurance contracts, and leases. The Board concluded that this would be beyond the scope of the project and that it should consider this aspect of presentation in the statement of profit or loss and other comprehensive income more broadly as part of the financial statement presentation project.

Future accounting standards still allowing for choices

18 Unhelpful accounting choices appear likely to feature in important future accounting standards. An example is lease accounting, as IFRS 16 includes a variety of options. One notable example concerns short-term leases and leases of small assets, which companies can choose to either include or exclude in their balance sheet liability.

19 Another option concerns the proposed methods of transition to the new lease accounting standard. These would let companies apply either a full retrospective approach or a modified retrospective approach, with various other options also buried within these two methods. Reading the basis of conclusions, it is clear that the standard setting process for IFRS 16 required the Board to balance a few trade-offs between stakeholders before arriving at the final standard.

Potential solution

20 The IASB could be encouraged to develop a principle – beyond the wording in the 2010 Conceptual Framework - to limit the number of accounting choices in accounting standards, wherever practical.

21 For example, such a principle could be developed as part of the Disclosure Initiative (a broad-based initiative to explore how disclosures can be improved), or the project to improve the Conceptual Framework, (the goal of which is to set out the concepts that underlie the preparation and presentation of financial statements).

22 Or perhaps better still, such a principle could be developed as part of the Primary Financial Statements project (formerly performance reporting). An objective of this project is for the IASB to examine the purpose, structure and content of the primary financial statements in relation to the usefulness to users. It would therefore seem appropriate, in terms of objective, to consider the removal of (some) policy options within the scope of this project.

23 Alternatively (or in addition) to developing a principle, some of the presentational options listed in Table 2 could be addressed on a case-by-case basis as part of the Primary Financial Statements project. Discussions with the IASB project team (Sue Lloyd,

Rachel Knubley, Koichiro Kuramochi) suggest that they are exploring, for example, requiring an operating profit total, revising the definition of operating cash flows and providing principles-based definitions of operating and financing activities.

Question for CMAC

24 Would CMAC members support the development of a principle limiting the number of accounting choices in accounting standards?

25 Would CMAC also support (or support instead) the idea of addressing this issue on an option by option basis as part of the Primary Financial Statements project?

Appendix – summary of work done on accounting options with EFRAG User Panel

- Paper on reducing accounting options was presented to EFRAG User Panel in December 2015.

- There was support among EFRAG User Panel members to encourage IASB to develop a principle to limit the number of accounting choices in accounting standards, wherever practical.

- The EFRAG Secretariat thinks that having fewer options in IFRS would enhance consistent application of IFRS and be consistent with feedback received from IASB's recent agenda consultation, where several respondents said that the IASB should focus on its implementation activities, rather than on new Standards-level projects. Important implementation activities noted include support for new and recently issued Standards and resolving issues arising from inconsistent application and inconsistencies between individual Standards.

- The EFRAG Secretariat thinks that if the IASB were to undertake work on reducing policy options in IFRS, it could first identify whether some options could be easily eliminated without the loss of information to users and additional cost to preparers (for example the more obvious cases where it is fairly clear which options are most commonly used and supported by users).