Revising for the September 2020 exam session

Part 3

Strategic Business Reporting (SBR)

Due to the change in timing of the ACCA exams, there are now a few extra weeks before the next exam session. With this in mind, the SBR examining team highlight a few areas of the syllabus that have caused candidates problems in recent exams and give some pointers on exam techniques, specific IFRS standards and current issues.

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Introduction

This article is the third in a series which aims to help those SBR candidates who are studying for the September 2020 exams, but also beyond that. Specifically, it explains a complex area of the SBR syllabus, the asset ceiling test in IAS 19 Employee Benefits, and explains how many IFRS standards and principles might be relevant to an accounting issue for which there is no existing IFRS standard (in this case Initial Coin Offering (ICO)). Finally, it examines some non-financial performance measures that have been reported in practice in a global digital entity.

However, first it is worth reiterating that candidates will not be able to successfully answer SBR questions by rote learning and reproducing textbook answers. Candidates should always explain the relevant principles which underpin their answers because in SBR, marks are awarded first for an explanation of the principles and then for their application to the scenario. An understanding of the principles will allow candidates to deal with the many accounting issues that arise in practice and to cope with the changes and developments in the business environment, such as ICO's. In addition, candidates will not be awarded professional marks if there is no reference to the scenario.

Asset ceiling test IAS 19

Defined benefit pension accounting is generally acknowledged to be a complex area of accounting and asset ceiling test is possibly one of the more complex aspects of IAS 19 Employee Benefits that might be examined. A pension asset exists when a defined benefit pension plan has a surplus of plan assets over its liabilities. IAS 19 requires the employer to consider the recoverability of any such surplus and there must be economic benefit (for example reduced contributions or a cash refund) available to the company to enable this recovery. An entity should recognise a net pension asset in such cases because the entity controls a resource, and that control is a result of past events. This is in the form of contributions paid by the entity and service rendered by the employee. Future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit. The asset ceiling is the present value of those future benefits.

IAS 19 states that, when an entity has a surplus in a defined benefit plan, it should measure the net defined benefit of the asset at the lower of:

i) the surplus in the defined benefit plan; and
ii) the asset ceiling,
Note: the asset ceiling will be provided as part of the question scenario in the SBR exam but in practice is determined using the discount rate based upon market yields at the end of the reporting period on high quality corporate bonds

A further issue can arise when a plan amendment, curtailment or settlement occurs. An entity should recognise any past service cost, or a gain or loss on settlement in profit or loss. In doing so, the entity should not consider the effect of the asset ceiling. After the plan amendment, curtailment or settlement has been accounted for, the entity should then determine the effect of the asset ceiling.

A plan amendment, curtailment or settlement might reduce or eliminate a surplus, which could impact on how the asset ceiling is measured. Any changes in the value of the asset ceiling is recognised in other comprehensive income, as opposed to being recognised in the statement of profit or loss.

Illustrative example

Apolline Co manages a defined benefit scheme for its employees. At 1 January 20X8, the fair value of the pension scheme assets were estimated to be $137 million and the present value of the pension scheme liabilities were $122 million. The asset ceiling has been calculated at $4 million. The discount rate on high quality corporate bonds is 4%. The following are the details of the scheme for the year to 31 December 20X8.

	$m
Cash contributions	7
Benefits paid	6
Current service cost	5

At 31 December 20X8, the asset ceiling has been calculated at $11 million. During the year, there was a scheme curtailment which resulted in a gain on settlement of $3 million. Immediately after the scheme curtailment the actuary valued the scheme's assets as $148 million and the scheme's liabilities as $136 million.

Suggested answer

At 1 January 20X8, the surplus of the scheme/net plan asset is $15 million ($137million - $122million). However, the asset ceiling is $4 million so the net defined benefit pension asset is restricted to this figure. Interest on the opening asset will be based upon this figure at $160,000 (4% X $4 million) and will be recorded in profit or loss. The cash contributions of $7 million will be added to the scheme assets, and the current service cost of $5 million charged to profit or loss. The benefits paid of $6 million are deducted from both the schemes assets and the schemes liabilities and therefore have a nil effect.

As any past service cost does not consider the effect on the asset ceiling, a gain on settlement of $3 million should therefore be recognised in profit and loss.

The pension scheme surplus at 31 December 20X8 is summarised as follows:

	Assets ($m)	Liabilities ($m)	Net plan asset before ceiling adjustment ($m)	Ceiling adjustment ($m)	Net plan asset after ceiling adjustment ($m)
Balance 1 January 20X8	137	122	15	(11)	4
Net interest at 4%	5.48 (4% x $137m)	4.88 (4% x $122m)	0.6	(0.44)	0.16 (4% x $4m)
Cash contributions	7		7		7
Benefits paid	(6)	(6)	-		
Current service cost		5	(5)		(5)
Curtailment and settlement		(3)	3		3
Total at 31 December 20X8	143.48	122.88	20.6	(11.44)	9.16

At 31 December 20X8, the scheme is now valued at the lower of the:

- surplus of the scheme, $12 million ($148million - $136million) and
- the present value of the economic benefits in the form of refunds from the plan or reductions in the future combinations (the asset ceiling) i.e.$11 million.

This means that there is a net gain of $1.84 million being the difference between the net plan asset in the scheme ($9.16 million) and the asset ceiling ($11 million). This gain is credited to other comprehensive income.

If the effect of the asset ceiling had not been taken into account, there would have been a remeasurement loss of $8.6 million ($20.6million-12million) at 31 December 20X8 which would have been recognised in other comprehensive income.

Understanding the context of Initial Coin Offering (ICO) tokens

SBR will often provide candidates with a scenario that they have not encountered before. These scenarios allow candidates to demonstrate their ability to apply accounting principles and show how more than one IFRS standard might be relevant. The next few paragraphs use an ICO to demonstrate how candidates should use accounting principles (such as control) and existing IFRS standards to suggest potential accounting treatments.

In an ICO (also called a 'token sale'), instead of receiving shares, participants (also known as supporters) receive 'tokens' and, instead of paying cash, participants often pay in cryptocurrency. They are similar in many ways to crowdfunding but for their 'support' they receive a reward i.e. the tokens. The tokens are a digital asset based on the same logic as cryptocurrencies, like Bitcoin. Although the tokens have no inherent value, if the ICO is successful, these new tokens will become valuable and a market to trade them will subsequently develop. If unsuccessful, then the tokens would have no value. ICOs raise money by issuing a 'white paper' that provides details of the proposed venture. This may be the development of a new app or product or service; for example, the development of an app to subsequently support the trade of the tokens. The tokens are usually issued in exchange for either conventional currency or cryptocurrency. As the ICO issues a token, rather than shares, they are not considered to be a securities offering, so the associated regulation and controls have not been applied.

There are ethical issues for accountants because the white paper may not properly represent the nature of the offer. For example, unrealistic forecasts or factual inaccuracies.

During the preparation for the ICO, the costs should be recognised as expenses if they don't satisfy the requirements for recognition of intangible assets in accordance with IAS 38 Intangible Assets. Following the circulation of the tokens, the issuing company generally loses control of the market of these tokens. However, if the issuer is able to get further economic benefits from token holders by providing them with intermediary or similar services that are not related to the subsequent sale of uncirculated tokens, then the costs may satisfy the requirements of IAS 38. Examples may be the management of the platform supporting the market of circulated tokens by annulling purchased tokens or changing the content of smart contracts (a computer program that executes, controls and documents legal events).

If all inflows received for tokens are in excess of the expenses of the initial ICO and are not related to further commitments to holders of tokens, such further inflows are considered as revenue by the issuer.

Sometimes the rights given to the token holders may be similar to the rights of the holders of debt, equity instruments or other financial instruments. For example, the issuer may contract to pay a fixed amount of annual profits to the token holder but not to redeem the tokens. At the initial recognition, such a

right is recorded as a contingent liability, the value of which depends on a future uncertain event, i.e. the annual profit margin. During the reporting period, the liability should be increased as the issuer earns profits.

Alternatively, the issuer may commit to the holders of tokens to pay annual interest based upon the fair value of a cryptocurrency. Such a liability should be recognised as a financial derivative.

Revenue recognition in accordance with IFRS 15 Revenue from Contracts with Customers is based on the transfer of control. Control is defined as the ability to direct the use of and obtain substantial control over the remaining benefits associated with the asset. The issuer therefore needs to determine if the transfer of control happens over time.

If control happens over time, revenue cannot be recognised in full at the time of the initial ICO sale. Instead, it must be recognised as the performance obligation is satisfied. This will most likely occur if the token is presented to the issuer for redemption into goods or services, such as granting access to software.

A useful background article can be found within the SBL technical articles here. Please note that this article is not examinable but is purely for additional reading.

Non-GAAP/non-financial performance measures and quarterly press releases

Finally, SBR candidates need to be able to understand additional performance measures (APMs) that are produced by companies in the context of their different business models. This final part of the article uses a social media company to demonstrate the range of APMs reported in practice.

Some companies issue quarterly press releases which contain forward-looking statements regarding the future expectations of the business. Often, they will supplement the consolidated financial statements with some non-GAAP financial measures. For example, some social media companies will report advertising revenue excluding foreign exchange effect and free cash flow. Investors are often cautioned that there are material limitations associated with the use of non-GAAP financial measures as an analytical tool. In addition, they state that these measures may be different from non-GAAP financial measures used by other companies, limiting their usefulness for comparison purposes. These non-GAAP measures are reported because they provide investors with useful supplemental information and allow for greater transparency with respect to key metrics used by management in operating their business.

SBR candidates need to be aware how these additional performance measures might be useful to users when provided in conjunction with financial statements that are compliant with IFRS standards. These measures are usually derived from the business model of the company; for example, a social media company will often publish ‘Operational and Other Financial Highlights’ which include a range of metrics that the directors feel are important to investors. They may include conventional profitability ratio’s such as earnings per share but also such things as:

- Social media monthly active users
- Family daily and monthly active people
- Family Average Revenue per Person
- Revenue by User Geography
- Advertising Revenue by User Geography
- Effective Tax Rate
- Free Cash Flow Reconciliation

Well known social media companies are quick to point out the limitations of some of the above ratios. For example, Facebook states that the numbers for their key metrics are calculated using internal company data based on the activity of user accounts. They try and eliminate the number of "duplicate" and "false" accounts among their users as many people use more than one of their products, and some have multiple user accounts within an individual product. The data regarding the geographic location of their users is estimated based on a number of factors, such as the user's IP address and self-disclosed location. These factors do not always accurately reflect the user's actual location.

It seems that for some digital companies, conventional financial accounting ratios cannot account for the importance of other effects such as the network or the increase in the value of a resource with its use. Hence some companies will use ratios which are particular to their type of digital business model.

SBR candidates must be able to discuss the issues raised by the increasing demand by various stakeholders for non-financial additional performance measures including transparency, consistency and comparability. There is a technical article that discusses additional performance measures which can be found here.

SBR candidates must be able to discuss the ethical issues associated with regards non-GAAP/non-financial performance measures being used, for instance conflicts of interests between managements interests and the investor perspective. The examples provided above raise many of these issues on the tensions between demand for more information from stakeholders and how it should be calculated and presented alongside IFRS standard disclosures.