

PRACTICAL EXPEDIENTS – A VALID TOOL IN IFRS STANDARD-SETTING?

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OVERVIEW

What?

We investigate so-called “practical expedients”, i.e. simplified accounting choices which are increasingly used in the development of IFRS Accounting Standards

How?

1. What practical expedients are available under IFRS? Why?
2. How did large listed European firms apply and disclose practical expedients during 2018-22?
3. Does the variation across firms matters to users?
4. What is stakeholders view on practical expedients in the standard-setting process?

Why?

- Principle-based IFRSs vs. overt deviations from those principles – is simplification a valid argument?

1. WHAT PRACTICAL EXPEDIENTS ARE AVAILABLE UNDER IFRS AND WHY?

PRACTICAL EXPEDIENTS IN IFRS

| Paragraph | Practical expedient | Disclosure requirement? | |
|----------------|---|-------------------------|---|
| IFRS 15.94 | Option to recognise the incremental costs of obtaining a contract as an expense if the amortization period would be one year or less | yes | IFRS15: 7 PEs, 5 with disclosure requirement |
| IFRS 15.B16 | Option to recognise revenue in the amount to which the entity has a right to invoice. | no | |
| IFRS 15.121 | Option to not disclose specific information about performance obligations | yes | |
| IFRS 15.4 | Option to apply IFRS 15 to a portfolio of contracts (or performance obligations) | no | |
| IFRS 15.63 | Option to not adjust for the significant financing component if the time between transfer of goods or services and the payment is less than one year. | yes | |
| IFRS 15.C5 | Transition | yes | IFRS16: 7 PEs, 4 with disclosure requirement |
| IFRS 15.C7a | Transition | yes | |
| IFRS 16.5 | Option to expense short-term leases and leases of low underlying value | yes | |
| IFRS 16.15 | Option to not separate non-lease components from the lease components | no | |
| IFRS 16.B1 | Option to apply IFRS 16 to a portfolio of leases. | no | |
| IFRS 16.46A | Option to not assess whether a COVID-19-related rent concession is a lease modification | yes | |
| IFRS 16.105 | Application of IFRS 16.42 to lease modifications required by the IBOR reform. | no | |
| IFRS 16.C3 | Transition | yes | |
| IFRS 16.C10 | Transition | yes | |
| IFRS 9.5.4.7 | Application of IFRS 9.B5.4.5 to account for a change in the basis for determining the contractual cash flows of a financial asset or financial liability that is required by the IBOR reform. | no | |
| IFRS 9.B5.5.35 | Option to use practical expedients in the measurement of ECLs (e.g., provision matrix), | no | |
| IFRS 13.71 | Practical expedients for fair value measurement within a bid-ask spread. | no | IFRS13: 2 PEs |
| | Option to measure fair value using an alternative pricing method that does not rely exclusively on quoted prices (e.g., matrix pricing) when an entity holds a large number of similar (but not identical) assets or liabilities. | no | |
| IFRS 13.79(a) | Option to simplify the measurement of a group of insurance contracts using the premium allocation approach under certain conditions. | yes | |
| IFRS 17.53-59 | A reporting entity is exempt from the disclosure requirements of paragraph 18 in relation to related party transactions and outstanding balances, including commitments, under government control. | yes | |
| IAS 24.25 | | yes | |

POSSIBLE REASONS FOR THE EMERGENCE OF PE:S IN THE IFRS STANDARDS (IASB LITERATURE REVIEW)



Costs vs. benefits of accounting treatments



Stakeholder pressures – simplified accounting solutions make preparers willing to accept a standard package



Aligning with FASB (IFRS BC 10.225, IFRS BC 16.135B, IFRS BC 15.297, IFRS BC 15.352)

2. HOW DO LARGE EUROPEAN FIRMS APPLY AND DISCLOSE PRACTICAL EXPEDIENTS?

SAMPLE AND DATA SELECTION

1. Identify largest listed companies in the 16 largest EU markets+ Norway and Switzerland in 2021
2. Focus on companies with operations in the same country
 - Exclude listed subsidiaries if parent is listed in the same country
 - Financial statements in English
 - Financial statement data available in **Capital IQ**
 - **20-25 companies per country**
3. Collect data on the use of identified PE:s for these companies
4. Analyst forecast and share price data obtained from I/B/E/S



428 firms & 2 094 firm-year observations (2 027 with full required financials)



1,226 firm-observations with I/B/E/S data

DISCLOSURE AND USE OF PRACTICAL EXPEDIENTS

of disclosures
of applied PEs
of not applied /
not material PEs

| Practical expedient disclosures | mean | min | max | of which: |
|---------------------------------|-------------|----------|----------|---------------------|
| → TOTAL_PE | 2.44 | 0 | 10 | |
| → APPLIED_PE | 2.17 | 0 | 8 | |
| → NAPPLIED_PE | 0.27 | 0 | 4 | |
| REVENUE_PE | 0.56 | 0 | 5 | |
| IFRS 15:4 | 0.02 | 0 | 1 | 0.00% do not apply |
| IFRS 15:94 ★ | 0.11 | 0 | 1 | 2.65% do not apply |
| IFRS 15:B16 | 0.04 | 0 | 1 | 0.00% do not apply |
| IFRS 15:63 ★ | 0.26 | 0 | 1 | 6.14% do not apply |
| IFRS 15:121 ★ | 0.11 | 0 | 1 | 0.00% do not apply |
| IFRS 15 transitory PEs ★ | 0.02 | 0 | 1 | 0.00% do not apply |
| LEASE_PE | 1.48 | 0 | 5 | |
| IFRS 16:5 ★ | 0.70 | 0 | 1 | 1.50% do not apply |
| IFRS 16:15 | 0.26 | 0 | 1 | 39.93% do not apply |
| IFRS 16:B1 | 0.05 | 0 | 1 | 7.27% do not apply |
| IFRS 16:46A ★ | 0.20 | 0 | 1 | 35.45% not material |
| IFRS 16.105 | 0.12 | 0 | 1 | 36.95% not material |
| IFRS 16 transitory PEs ★ | 0.14 | 0 | 1 | 0.00% do not apply |
| FIN_PE | 0.38 | 0 | 2 | |
| IFRS 9.B5.5.35 | 0.26 | 0 | 1 | 0.00% do not apply |
| IFRS 9.5.4.7 | 0.12 | 0 | 1 | 13.90% not material |
| IAS 24:25 ★ | 0.02 | 0 | 1 | 13.73% do not apply |

“is not material because we do not have such (...)”

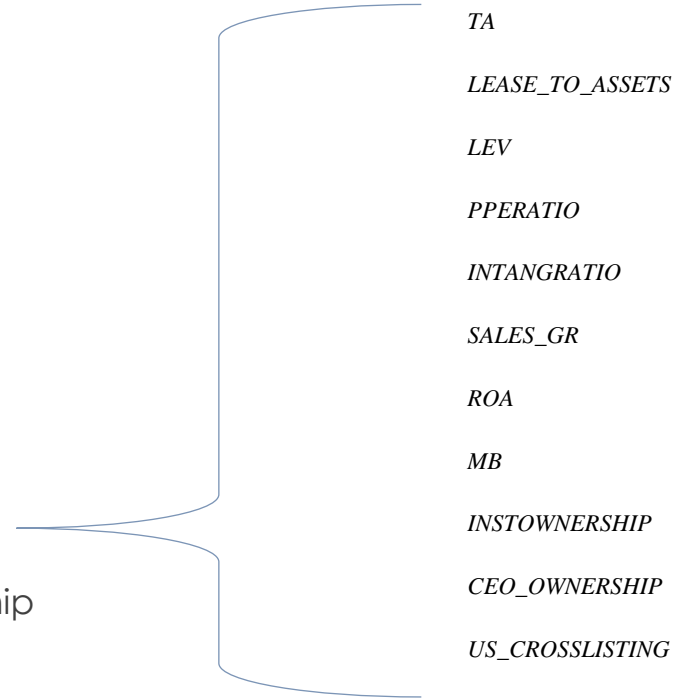
“does not significantly affect our reported (...)”

PRACTICAL EXPEDIENT DISCLOSURE BY YEAR

| year | TOTAL_PE | APPLIED_PE | NAPPLIED_PE | REVENUE_PE | LEASE_PE | FIN_PE | IAS2425_PE |
|------|----------|------------|-------------|------------|----------|--------|------------|
| 2018 | 1.83 | 1.78 | 0.05 | 0.53 | 1.01 | 0.27 | 0.02 |
| 2019 | 2.50 | 2.31 | 0.19 | 0.49 | 1.62 | 0.36 | 0.02 |
| 2020 | 2.80 | 2.35 | 0.44 | 0.53 | 1.77 | 0.47 | 0.02 |
| 2021 | 2.92 | 2.43 | 0.49 | 0.68 | 1.75 | 0.46 | 0.03 |
| 2022 | 2.15 | 1.97 | 0.19 | 0.56 | 1.23 | 0.34 | 0.02 |

FACTORS ASSOCIATED WITH THE PRACTICAL-EXPEDIENT DISCLOSURE AND USE

- Year
 - Adoption year
 - Temporary rules (COVID-19; IBOR; transitory)
- Industry
 - Most frequent in mining, manufacturing, transportation & utilities
- Country
 - relative importance of capital markets (-)
 - tax system complexities (+)
 - rule-of-law (+)
- Firm-level characteristics
 - Firm size (total assets) (+)
 - Sales growth, ROA, PPE, institutional ownership (weakly)



3. ANY EVIDENCE OF THE INFORMATION QUALITY ISSUES?

ACCOUNTING QUALITY

ABNACC: Absolute abnormal accruals calculated based on Kothari et al. (1995) using the model of Hope et al. (2017). Absolute values are multiplied by (-1). **Higher ABNACC indicates higher accounting quality.**

| VARIABLES | (1) | (2) | (3) |
|-----------------|--------------------------------|-----------------------|-----------------------|
| | ABNACC | ABNACC | ABNACC |
| TOTAL_PE | -0.000 (-0.092) | | |
| APPLIED_PE | | -0.000 (-0.007) | |
| NAPPLIED_PE | | -0.001 (-0.352) | |
| REVENUE_PE | | | 0.000 (0.169) |
| LEASE_PE | | | 0.002 (0.979) |
| FIN_PE | | | -0.007 (-1.613) |
| IAS2425_PE | | | -0.004 (-0.280) |
| TA | 0.020*** (5.456) | 0.020*** (5.468) | 0.020*** (5.452) |
| LEV | 0.054** (2.159) | 0.054** (2.148) | 0.055** (2.162) |
| MB | -0.002 (-1.018) | -0.002 (-1.021) | -0.002 (-1.042) |
| ROA | -0.143** (-2.478) | -0.143** (-2.479) | -0.145** (-2.509) |
| SALES_GR | -0.009 (-0.931) | -0.009 (-0.924) | -0.009 (-0.919) |
| US_CROSSLISTING | -0.036*** (-3.744) | -0.036*** (-3.741) | -0.036*** (-3.719) |
| Constant | -0.255*** (-7.247) | -0.255*** (-7.259) | -0.254*** (-7.262) |
| Fixed effects | Year, industry, and country FE | | |
| Observations | 2,022 | 2,022 | 2,022 |
| Adj. R2 | 0.380 | 0.379 | 0.380 |

ANALYST FORECAST PROPERTIES

ACCURACY: The absolute value of the difference between the median analyst forecast EPS estimate and actual EPS for year t , scaled by $t-1$ financial year-end share price, and multiplied by (-1) . Winsorized at 1% and 99%. First analyst forecasts for year t issued after the release of the $t-1$ annual report are used. **Higher value indicates higher accuracy.**

Dispersion: Standard deviation of the analyst EPS forecasts for year t , scaled by $t-1$ financial year-end share price. Winsorized at 99%. First analyst forecasts for year t issued after the release of the $t-1$ annual report are used. **Higher value indicates higher dispersion.**

| | (1) | (2) | (3) | (4) | (5) | (6) |
|----------------------------|----------------------------|--------------------|---------------------|------------------|------------------|--------------------|
| VARIABLES | ACCURACY | | | DISPERSION | | |
| TOTAL PE | -0.002 (-1.142) | | | 0.002 (0.703) | | |
| APPLIED PE | | -0.002 (-1.028) | | | 0.000 (0.153) | |
| NAPPLIED PE | | -0.003 (-0.514) | | | 0.011 (1.103) | |
| REVENUE PE | | | -0.003 (-0.705) | | | 0.010 (1.179) |
| LEASE PE | | | 0.003 (0.846) | | | -0.008 (-1.228) |
| FIN PE | | | -0.013* (-1.892) | | | 0.013 (1.183) |
| IAS2425 PE | | | -0.029 (-1.505) | | | 0.023 (0.759) |
| Firm-level controls | Yes | Yes | Yes | Yes | Yes | Yes |
| Fixed effects | Year, industry, country FE | | | | | |
| Observations | 1,226 | 1,226 | 1,226 | 1,226 | 1,226 | 1,226 |
| Adj. R2 | 0.300 | 0.300 | 0.304 | 0.327 | 0.327 | 0.330 |

VALUE RELEVANCE (OHLSON (1995))

$$\begin{aligned}
 MB_{i,t} &= \alpha + \alpha_1 \frac{1}{B_t} + \alpha_2 ROE_{i,t} + \alpha_3 \sum PE_{i,t} \\
 &+ \alpha_4 ROE_{i,t} \times \sum PE_{i,t} + \sum FE + \varepsilon_{i,t}
 \end{aligned}$$

| | (1) | (2) | (3) |
|-------------------|---------------------|----------------------|-----------------------|
| VARIABLES | MB | MB | MB |
| INV_BV | 56.264** (2.110) | 59.800** (2.370) | 55.870** (2.071) |
| ROE | 9.308*** (4.656) | 9.151*** (4.624) | 9.236*** (4.300) |
| TOTAL_PE | -0.022 (-0.272) | | |
| ROE × TOTAL_PE | -0.919* (-1.736) | | |
| APPLIED_PE | | -0.019 (-0.212) | |
| ROE × APPLIED_PE | | -0.651 (-1.157) | |
| NAPPLIED_PE | | -0.071 (-0.363) | |
| ROE × NAPPLIED_PE | | -2.408** (-2.200) | |
| (...) | | | |
| IAS2425_PE | | | -0.146 (-0.364) |
| ROE × IAS2425_PE | | | -7.149*** (-3.929) |
| Constant | 2.108*** (6.644) | 2.099*** (6.695) | 2.151*** (6.467) |
| Observations | 2,027 | 2,027 | 2,027 |
| Adj. R2 | 0.403 | 0.406 | 0.407 |

4. WHAT ARE THE STAKEHOLDER VIEWS?

ADDITIONAL OBSERVATIONS FROM INTERVIEWS



Interviewees

2 representatives of a preparer perspective; and 2 of a standard setter perspective



Perceived role of PE:s

Despite the lack of a definition, all agree that practical expedients are introduced to balance the costs and benefits of the standards, and a tool for the IASB in developing the standards.



PE:s and materiality

Certain differences in the views on the emergence and application of the practical expedients and the materiality considerations in financial reporting.



Application of PE:s

PE:s are considered at the implementation stage and are subsequently maintained.



Assessment of PE:s as part of the IFRSs

Tensions associated with the applications of rules-based PE:s within the principles-based IFRS Standards; but the option of a simplified accounting approach is generally perceived favourably.

CONCLUSIONS

- **Broad use** of practical expedients across countries and industries
- **Country-level institutional factors and industry affiliations explain more variation** in the practical-expedient use than firm-level factors.
- The use of practical expedients **is not/weakly associated** with accounting quality, analyst forecast accuracy and dispersion, and value relevance of reported firm performance.

Practical expedients seem to have the potential to facilitate IASB's standard-setting work without impairing the informational properties of the resulting financial statements.

Our results are only based on the currently available practical expedients; and we cannot observe used but non-disclosed PEs

Increasing reliance on practical expedients may challenge the primacy of the principles-based standard setting

THANK YOU!