FOUNDATION EXAMS

FINANCIAL ACCOUNTING AND REPORTING

CPA AUSTRALIA

STUDY GUIDE

Foundation exam

Financial Accounting and Reporting

CPA AUSTRALIA

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FOUNDATION EXAMS

International Education Standards

CPA Australia is a member of the International Federation of Accountants (IFAC). All foundation exam education materials are developed in line with IFAC's International Education Standards. These standards provide guidance in establishing the content of professional accounting education programs together with the associated assessment. The standards also assist in developing the required passing standard for accounting education and competence of a professional accountant.

The foundation exams provide you with the opportunity to demonstrate your competence in areas required for Associate membership of CPA Australia. By demonstrating this entry level knowledge you will be well positioned to succeed at the CPA Program and ultimately attaining the CPA designation.

YOU AND YOUR STUDY PLAN

This Study Guide is designed to give you an understanding of what to expect in your exam as well as covering the fundamentals that you need to know. Exams will be based on the contents of the current Study Guide. You will need to check My Online Learning to confirm which version you should use based on your exam date.

There are no specifically recommended hours of study. Each candidate brings their own level of experience and knowledge to the foundation exams. The number of study hours required is entirely dependent on your prior knowledge of the subject. You will need to develop your own study plan. Refer to Preparing for your foundation exam on page vii.

ADDITIONAL LEARNING SUPPORT

If you feel you have gaps in your knowledge after reviewing the Study Guide, there is a range of optional additional support to assist in your exam preparation. Additional learning support caters for different learning styles and budgets.

Please check the CPA Australia website for more information www.cpaaustralia.com.au/cpa-program/cpa-program-candidates/your-in-semester-support/learning-resources/foundation

STANDARDS AND LEGISLATION

The material in this Study Guide has been prepared based upon selected standards from the IASB. Candidates are advised that they should use this Study Guide as the primary resource for their studies as the standards are frequently updated. Exams are based on the learning objectives outlined within this Study Guide.

MODULE FEATURES

Each module contains a number of helpful features to guide you through each topic.

Learning objectives — Show the referenced CPA Australia learning objectives.

Topic list — Tells you what you will be studying in this module.

Module outline — Presents a general idea of what is covered in this module.

Module summary diagram — Summarises the content of the module, helping to set the scene so that you can understand the bigger picture.

Before you begin — A small bank of questions to test any pre-existing knowledge that you may have of the module content. If you get them all correct then you **may** be able to reduce the time you need to spend on the particular module. There is a commentary section at the end of the Study Guide called *Before you begin questions: Answers and commentary*.

Section overview — Summarises the key content of the particular section that you are about to start.

Learning objective reference — Indicates the learning objective covered by the section or paragraph to which it relates.

LO 1.2

Definition — Definitions of important concepts. You really need to know and understand these before the exam.

Exam comments — Highlight points that are likely to be particularly important or relevant to the exam. (Please note that this feature does not apply in every foundation exam Study Guide.)

Worked Example — An illustration of a particular technique or concept with a solution or explanation provided.

Question — A question that enables you to practise a technique or test your understanding. You will find the solution at the end of the module.

Key module points — Reviews the key areas covered in the module.

Quick revision questions

A quick test of your knowledge of the main topics in this module.

The quick revision questions are not a representation of the difficulty or style of questions which will be in the exam. They provide you with an opportunity to revise and assess your knowledge of the key concepts covered in the materials so far. They are not a practice exam, but rather a means to reflect on key concepts and not as the sole revision for the exam.

Revision questions

The revision questions are not a representation of the difficulty or style of questions which will be in the exam. They provide you with an opportunity to revise and assess your knowledge of the key concepts covered in the materials so far. They are not a practice exam, but rather a means to reflect on key concepts and not as the sole revision for the exam.

Case study

A practical example or illustration, usually involving a real world scenario.

Formula to learn

Formulae or equations that you need to learn as you may need to apply them in the exam.

Bold text

Throughout the Study Guide you will see that some of the text is in **bold type**. This is to add emphasis and to help you to grasp the key elements within a sentence and paragraph.

PREPARING FOR YOUR FOUNDATION EXAM

STUDY PLAN

- Review all the learning objectives thoroughly. Use the weightings provided in the learning objectives table (see Learning Objectives section) to develop a study plan to ensure you provide yourself with enough time to revise each learning objective.
- Don't leave your study to the last minute. You may need more time to explore learning objectives in greater detail than initially expected.
- Be confident that you understand each learning objective. If you find that you are still unsure after reading the Study Guide, seek additional information from other resources such as text books, supplementary learning materials or tuition providers.

STUDY TECHNIQUES

- In addition to being able to complete the revision and self-assessment questions in the Study Guide, ensure you can apply the concepts of the learning objectives rather than just memorising responses.
- Some exams have formulae and discount tables available to candidates throughout the exams. My Online Learning lists the tools available for each exam. Also see Computer-based exam navigation section.
- Check My Online Learning on a weekly basis to keep track of announcements or updates to the Study Guide.

TIPS FOR EXAMS

- Plan to arrive at the exam centre at least 15 minutes before your exam. Allow for possible delays with public transport or traffic.
- You have three hours and fifteen minutes to complete the exam. As soon as you commence the exam your exam clock in the top right hand corner of the screen begins to count down. Watch your time carefully.

ANSWERING MULTIPLE CHOICE QUESTIONS

Foundation exams are a series of 100 multiple choice questions. Each question will contain four possible options.

Step 1 Attempt every question. Read the question thoroughly. You may prefer to work out the answer before looking at the options, or you may prefer to look at the options at the beginning. Adopt the method that works best for you.

Step 2 Read the four options and see if one matches your own answer. Be careful with numerical questions, as some options are designed to match answers that incorporate common errors. Check that your calculation is correct. Have you followed the requirement exactly? Have you included every step of the calculation?

Step 3 You may find that none of the options matches your answer.

- Re-read the question to ensure that you understand it and are answering the requirement.
- Eliminate any obviously wrong answers.
- Consider which of the remaining answers is the most likely to be correct and select the option.

Step 4 If you are still unsure, you can flag the question and continue to the next question. Some questions will take you longer to answer than others. Try to reduce the average time per question, to allow yourself to revisit problem questions at the end of the exam.

Revisit unanswered questions. A review tool is available at the end of the exam, which allows you to Review Incomplete or Review Flagged questions. When you come back to a question after a break you often find you are able to answer it correctly straight away. You are not penalised for incorrect answers, so **never leave a question unanswered!**

COMPUTER-BASED EXAM NAVIGATION

Your computer-based exam has the following functions:

- Navigation
  - You can select your answer by: clicking on the circle to the left of the option, or typing the letter corresponding to the option.
  - To move through the exam, you use the 'Next' or 'Previous' buttons on the bottom of the screen. The function of each button is selected by your mouse, or with a combination of keyboard keys. For example, you can select the 'Next' button by clicking it with the mouse, or by typing ALT + N.
  - The 'Next' button moves you from one screen to the next screen. If you wish to go back and view the screen you just viewed, click the 'Previous' button or type ALT + P.
  - There is also a 'Navigator' button on the bottom of the screen which allows you to click ahead to any question in the exam. This button can be accessed using your mouse or ALT + V. 'Navigator' allows you to see a list of all questions and their status including 'Incomplete'/'Complete' and 'Unseen'. Any questions you have flagged for review will also be shown in this view.
- Formulae
  - A 'Formulae' button is included in the computer-based exam for this subject.
  - The 'Formulae' button allows you to view the formulae provided in this Study Guide (see Formulae section).
  - The 'Formulae' button is located at the bottom of the screen, to the left of the 'Navigator' button.
- Select for review
  - There is a flag in the upper right corner of your exam screen labelled 'Flag for Review'. Alternatively you can use ALT + F to flag a question. You mark an exam question to review at a later time by clicking on this flag. The flag will appear filled-in once it is selected. You may mark any exam question for later review, whether you select an answer or not.
- Review screen
  - After finishing the last exam question, you will see a review screen. This lists every exam question. If you clicked the 'Flag for Review' flag on a question screen, that question appears on the Review screen marked with the flag filled in.
  - If you skipped any exam questions, these will be labelled as 'Incomplete' even if you did not select them for review.
  - From the Review screen you can choose to:
    1. review all of the questions in the exam by clicking 'Review All';
    2. individually select questions for review (click on the question number) or choose more questions for review (click on the flags corresponding to the questions);
    3. review all questions marked as incomplete by clicking 'Review Incomplete';
    4. begin reviewing the selected review questions by clicking 'Review Flagged'; or
    5. exit by clicking 'End Review' – this will also end your exam.

MODULE SUMMARY

This summary provides a snapshot of each of the modules, to help you to put the syllabus as a whole and the Study Guide itself into perspective.

Modules 1 and 2 mainly focus on the accounting concepts and principles and theories that are relevant to financial accounting and reporting. Modules 3, 4 and 5 then cover the actual preparation and presentation of financial statements for limited liability companies, both single companies and groups of companies, with Module 4 focusing particularly on the application of specific accounting standards. Finally, Module 6 covers the analysis and interpretation of financial statements.

MODULE 1 – THE FINANCIAL REPORTING ENVIRONMENT

In this module we will begin by considering the purpose of financial reporting and in particular who the financial statements are prepared for – the users of financial statements – and their information needs. We will also consider the regulatory framework within which international accounting standards are prepared and how this contributes to international GAAP.

The IASB's *Conceptual Framework for Financial Reporting* sets out and explains the concepts and principles on which, in theory, IFRSs are based. We look at the advantages and disadvantages of using a conceptual framework and also at the objectives of general purpose financial reports: financial statements prepared for users external to a business.

We also consider accounting policies: the specific principles and conventions that an entity adopts in preparing and presenting financial statements.

This module also explains the concepts that underlie the preparation of financial statements and the qualities that financial information must have if it is to be useful to the users of financial statements.

This module ends with a consideration of the elements of financial statements as set out in the IASB's *Conceptual Framework* – these are assets, liabilities, equity, income and expenses. You will learn the recognition criteria for each of these elements.

MODULE 2 – THE ACCOUNTING THEORY

The most common measure of asset/liability valuation is historical cost. However, in this module you will learn how to identify, explain and calculate other methods of valuation. You will also consider alternative methods of measuring capital and how this ties in with asset/liability valuation.

In a company the shareholders are the owners, but the company is managed by the directors. The directors are agents of the shareholders, therefore you will consider what is meant by agency theory. You will also look at the various types of information within a company's annual report and financial statements that are available to shareholders and other users. Some of this information helps the shareholders to assess the performance of the company and of its directors.

MODULE 3 – FINANCIAL STATEMENTS

In this module we begin by looking at the overall format and content of company financial statements as set out in IAS 1 (revised) *Presentation of Financial Statements*. The module covers the statement of profit or loss and other comprehensive income, the statement of financial position and the statement of cash flows (IAS 7 *Statement of Cash Flows*).

MODULE 4 – APPLICATION OF SPECIFIC ACCOUNTING STANDARDS

In this module, we consider in detail the application of specific accounting standards, in particular the accounting treatment of intangible non-current assets in general and research and development costs, as well as the accounting treatment in situations where assets (tangible or intangible), fall in value. The module moves on to the topical areas of revenue recognition and accounting for current

tax and deferred tax. The module then covers the accounting treatment of leases. It ends with a consideration of foreign currency accounting. There are two main aspects to dealing with foreign exchange – firstly, many companies will buy or sell goods from or to another country and in a foreign currency. These transactions in the foreign currency must be translated before they can be included in the financial records. The second aspect is that groups may include a foreign subsidiary and before the subsidiary's results can be included in the group financial statements the subsidiary's own financial statements must be translated.

MODULE 5 – BUSINESS COMBINATIONS

This detailed module will be looking at the techniques for preparing group financial statements or consolidated financial statements. It begins with a consideration of the major definitions and principles of consolidation which are vital to your understanding of the subject. Next we will study the basic procedures for producing a consolidated statement of financial position. Plenty of question practice is required but if you understand the basic steps and workings at this stage then your further studies of consolidated financial statements will become much easier. We move on to covering the preparation of the consolidated statement of profit or loss. This module ends with an examination of the accounting treatment of associated companies – the equity method of accounting.

MODULE 6 – ANALYSIS OF FINANCIAL STATEMENTS

In this module we consider the interpretation of financial statements by looking at the calculation of a number of different ratios and more importantly how these ratios can be used to analyse and interpret the financial statements. We shall also consider the limitations of financial analysis.

LEARNING OBJECTIVES

CPA Australia's learning objectives for this Study Guide are set out below. They are cross-referenced to the module in the Study Guide where they are covered.

GENERAL OVERVIEW

This exam covers an understanding of the format and function of financial statements, including analysis and interpretation of financial statements. It also includes the production of financial statements for consolidated company groups, and foreign currency translation.

This exam covers a critical awareness of accounting issues in an international context. It requires an understanding of the theoretical concepts within the regulatory and conceptual framework of corporate reporting. This includes recognition criteria, methods of valuation, and reporting and disclosure of the financial performance of companies.

These are the Learning Objectives that will be covered in the exam.

Module	Learning Objectives (LO)		Weighting
Module 1 The financial reporting environment	LO1.1	Describe the regulatory environment for financial reporting in Australia and the reasons for accounting and reporting requirements	28%
	LO1.2	Discuss the main types of business entity and explain the reasons for selecting each structure.	
	LO1.3	Identify different types of accounting regulation, including laws, Generally Accepted Accounting Principles and International Financial Reporting Standards.	
	LO1.4	Explain how the requirements from users, together with social and environmental developments, impact the underlying principles and requirements of financial reporting and the desire to establish a single set of international accounting standards.	
	LO1.5	Describe the role of the International Accounting Standards Board in developing a regulatory framework and explain how new policies and standards are established.	
	LO1.6	Identify the purpose of a conceptual framework and the key characteristics in the Generally Accepted Accounting Principles (GAAP) and apply the knowledge to define and recognise the different elements of the financial statements.	
	LO1.7	Describe and demonstrate the role of accounting standards and accounting policies in fairly presenting the financial performance and financial position of an entity.	

Module	Learning Objectives (LO)		Weighting
Module 2 The accounting theory	LO2.1	Compare historical cost accounting with other methods of valuation and explain the differences.	17%
	LO2.2	Explain agency and contracting theories and how they relate to accounting policy choice (positive accounting theory).	
	LO2.3	Apply the recognition criteria for the elements of the financial statements according to the conceptual framework (normative theory).	
Module 3 Financial statements	LO3.1	Prepare and present the statement of profit or loss and other comprehensive income with appropriate disclosure in accordance with relevant accounting standards and policies.	17%
	LO3.2	Prepare and present the statement of financial position with appropriate disclosure in accordance with relevant accounting standards and policies.	
	LO3.3	Prepare and present the statement of cash flows in accordance with relevant accounting standards and policies.	
	LO3.4	Demonstrate the ability to detect, investigate and correct discrepancies or particular items/events while matching the financial statements to supporting documentation.	
Module 4 Application of specific accounting standards	LO4.1	Calculate the carrying amounts of different classes of intangible assets and prepare the relevant journal entries.	15%
	LO4.2	Interpret contracts to determine the amount and timing of revenue to be recognised in the financial statements and reconcile the differences between ledgers if necessary.	
	LO4.3	Calculate current and deferred income tax and prepare the relevant journal entries to record the tax effect in the financial statements.	
	LO4.4	Calculate and account for foreign currency transactions at transaction date and subsequent dates	
	LO4.5	Translate financial statements from a functional currency to a presentation currency	

Module	Learning Objectives (LO)		Weighting
Module 5 Business combinations	LO5.1	Discuss the accounting issues for various forms of business combinations.	13%
	LO5.2	Explain how goodwill is measured and disclosed at the date of acquisition and prepare the relevant journal entries.	
	LO5.3	Explain how goodwill is measured and impaired subsequent to acquisition and prepare the relevant journal entries	
	LO5.4	Discuss the concept of control and calculate the non-controlling interest share of equity.	
	LO5.5	Prepare consolidated statements of financial position, including the entries for goodwill and non-controlling interests.	
	LO5.6	Prepare consolidated statements of profit or loss and other comprehensive income, including the entries for non-controlling interests and intra-group transactions.	
Module 6 Analysis of financial statements	LO6.1	Calculate, analyse and interpret financial ratios and their interrelationship in the financial statements.	10%
	LO6.2	Explain the limitations of financial statement analysis.	

MODULE 1 THE FINANCIAL REPORTING ENVIRONMENT

Learning objectives	Reference
Describe the regulatory environment for financial reporting in Australia and the reasons for accounting and reporting requirements	LO1.1
Discuss the main types of business entity and explain the reasons for selecting each structure	LO1.2
Identify different types of accounting regulation, including laws, Generally Accepted Accounting Principles and International Financial Reporting Standards	LO1.3
Explain how the requirements from users, together with social and environmental developments, impact the underlying principles and requirements of financial reporting and the desire to establish a single set of international accounting standards	LO1.4
Describe the role of the International Accounting Standards Board in developing a regulatory framework and explain how new policies and standards are established	LO1.5
Identify the purpose of a conceptual framework and the key characteristics in the Generally Accepted Accounting Principles (GAAP) and apply the knowledge to define and recognise the different elements of the financial systems	LO1.6
Describe and demonstrate the role of accounting standards and accounting policies in fairly presenting the financial performance and financial position of an entity	LO1.7

Topic list

1 The purpose of accounting
2 Nature, principles and scope of financial reporting
3 The reporting entity
4 Users' and shareholders' needs
5 The need for a regulatory framework
6 The IFRS Foundation and the IASB
7 Conceptual framework and GAAP
8 The IASB's *Conceptual Framework*
9 The objective of general purpose financial reporting
10 Accounting regulation

Topic list

11 Future developments
12 Accounting policies
13 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
14 The role of accounting standards
15 Accounting standards and choice
16 Accounting concepts
17 Qualitative characteristics of financial information
18 International Financial Reporting Standards
19 Developments in international harmonisation
20 The elements of financial statements
21 Recognition of the elements of financial statements
22 Applying the recognition criteria
23 The main financial statements

MODULE OUTLINE

This module introduces some basic ideas about the need for financial information and the users of financial information. It also covers the definition of financial reporting.

We then move on to look at the different sources of accounting regulation. Accounting is regulated by local statute (such as company law), by stock exchange requirements and by accounting standards. We will focus in particular on the activities of the International Accounting Standards Board (IASB) which is responsible for setting International Financial Reporting Standards (IFRS).

We will discuss the importance of IFRS in the global regulation of accounting and the process the IASB undertakes in issuing a new accounting standard.

We move on to look at the IASB's *Conceptual Framework for Financial Reporting* which represents the **theoretical framework** upon which all IFRS are based.

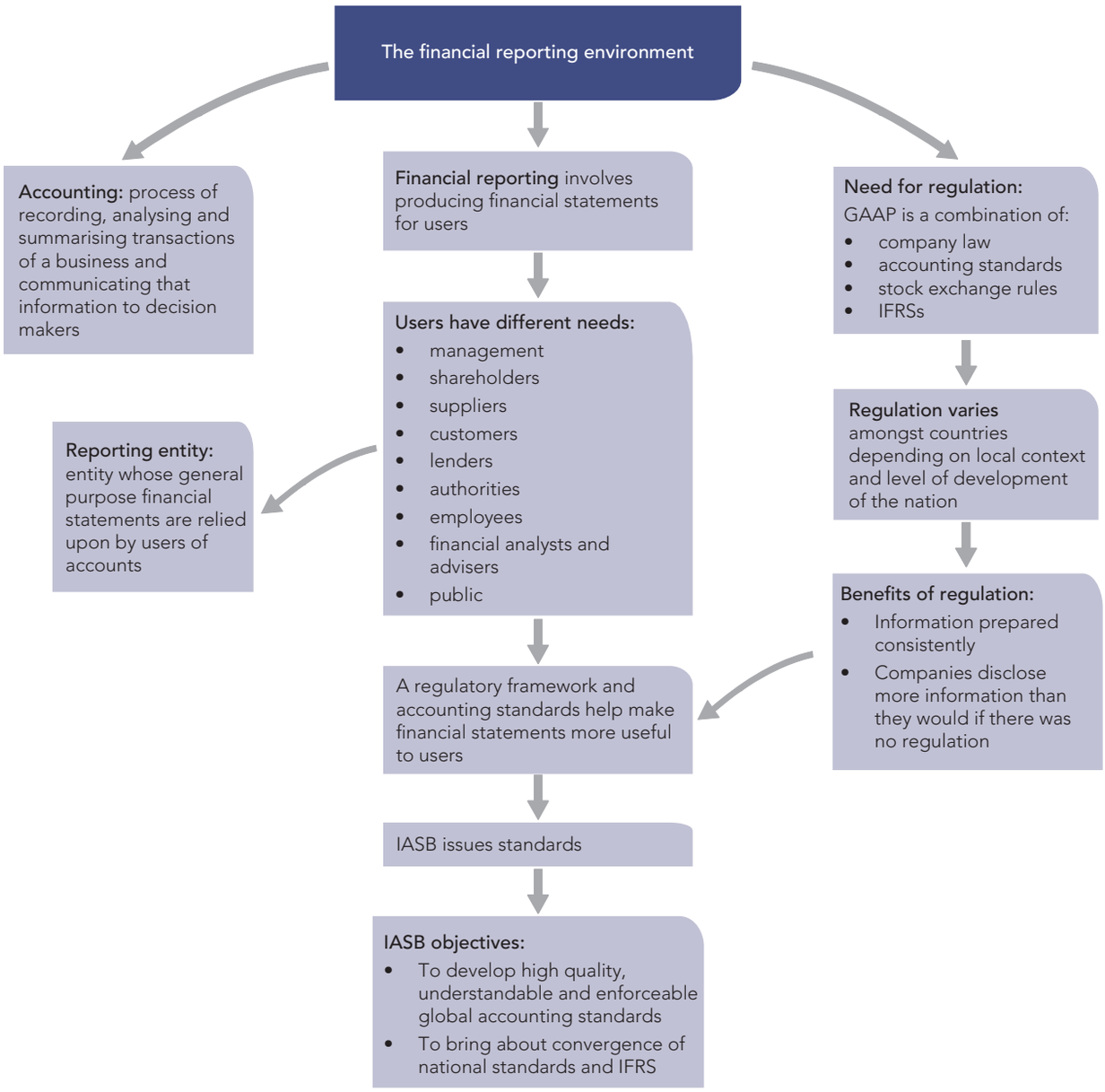
We also consider accounting policies: the specific principles and conventions that an entity adopts in preparing and presenting financial statements. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* explains how an entity should select and apply accounting policies.

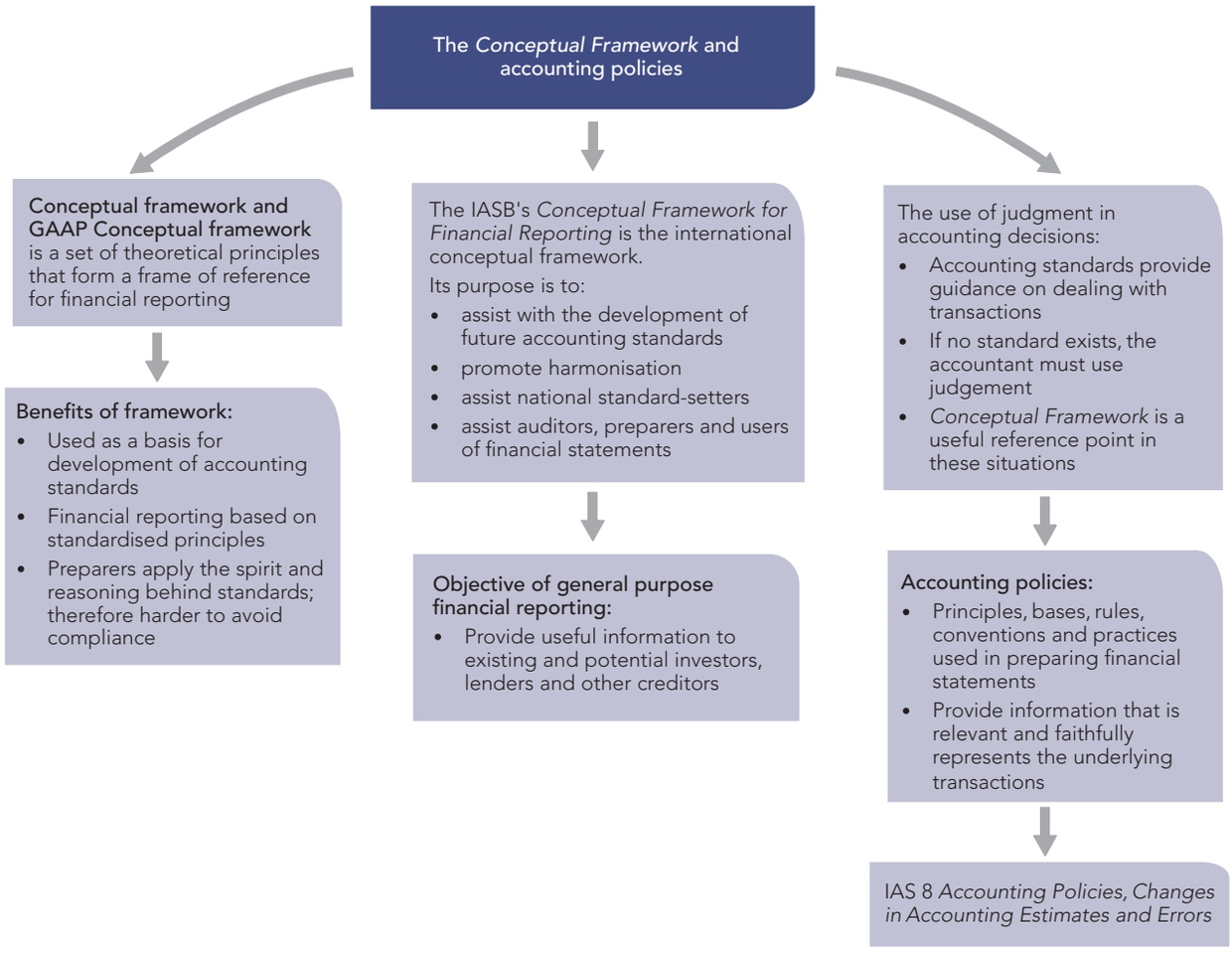
We examine the role and purpose of accounting standards in the regulation of financial reporting. We will look at this in the context of accounting policies and achieving the aim of preparing useful financial information.

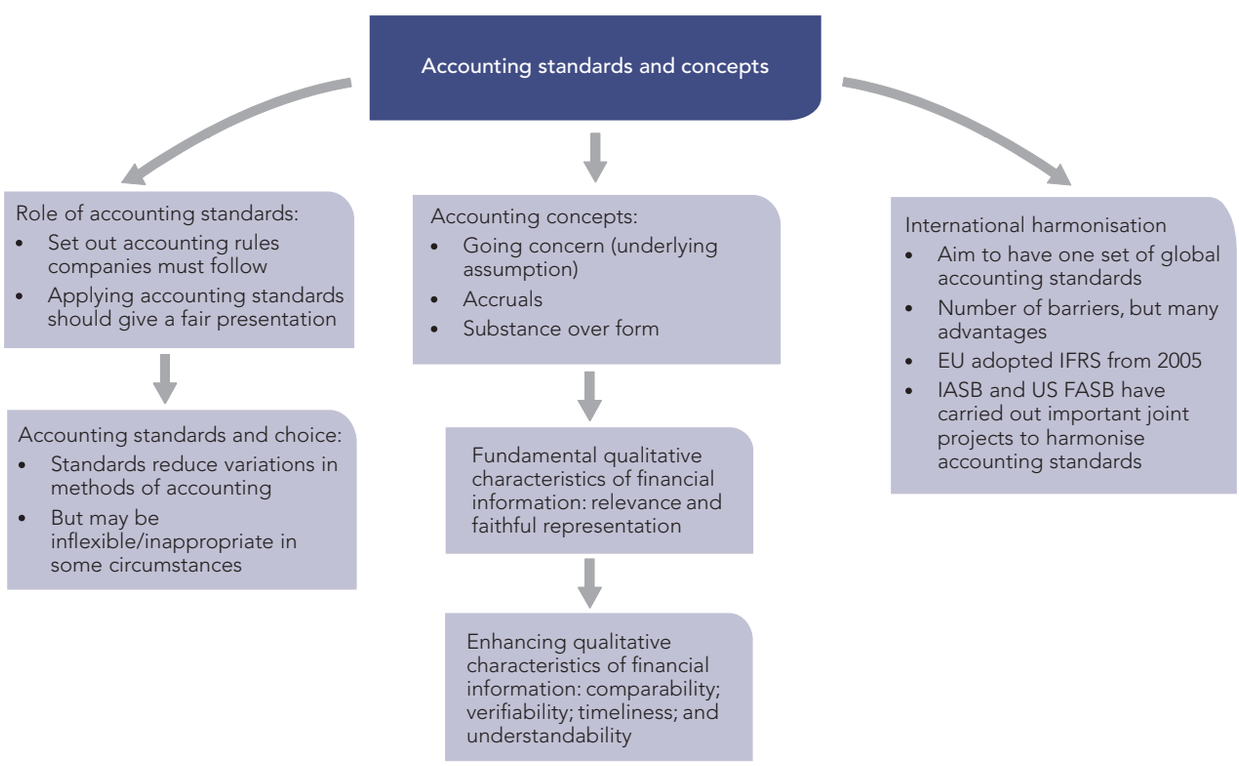
We will also review some of the key accounting concepts that have to be considered when preparing financial statements and discuss the process of harmonisation of accounting standards on a global basis.

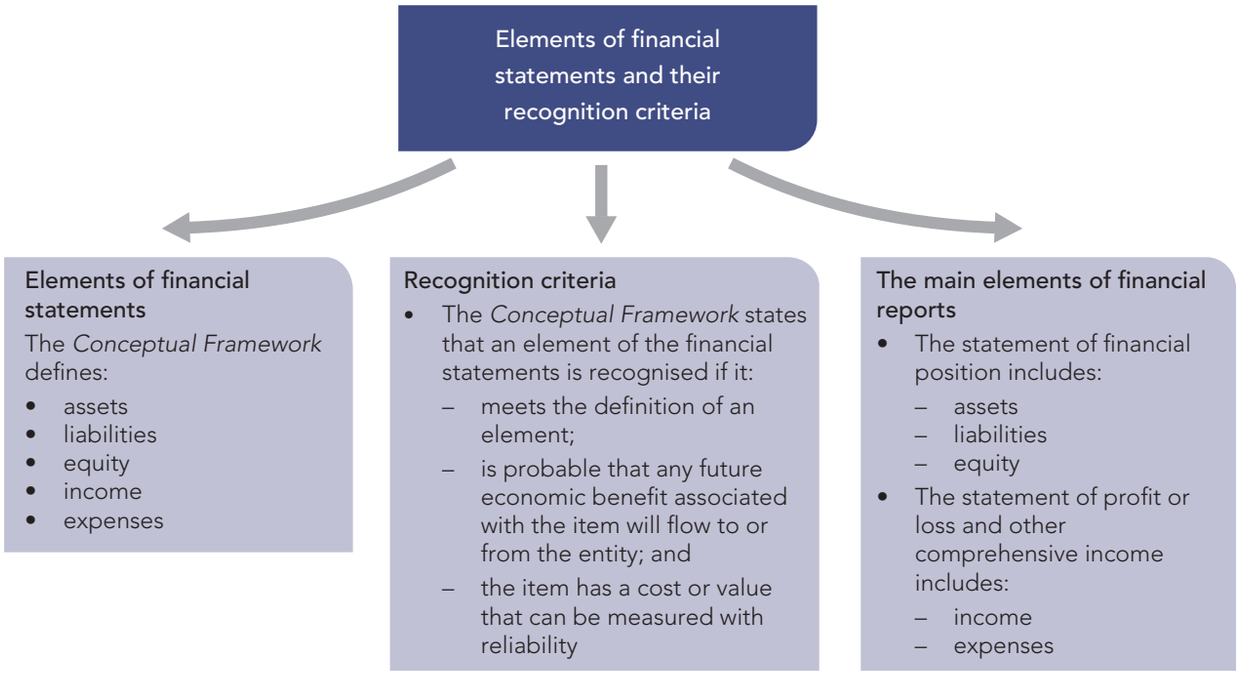
We will examine the main elements of financial statements: assets, liabilities, equity, income and expenses. Finally, we will look at the financial statements where these items are recognised and examine the recognition criteria for each of the elements of the financial statements.

The module content is summarised in the diagrams below.


The financial reporting environment
Accounting: process of recording, analysing and summarising transactions of a business and communicating that information to decision makers
Financial reporting involves producing financial statements for users
Need for regulation:
GAAP is a combination of:
• company law
• accounting standards
• stock exchange rules
• IFRSs
Users have different needs:
• management
• shareholders
• suppliers
• customers
• lenders
• authorities
• employees
• financial analysts and advisers
• public
Reporting entity: entity whose general purpose financial statements are relied upon by users of accounts
Regulation varies amongst countries depending on local context and level of development of the nation
Benefits of regulation:
• Information prepared consistently
• Companies disclose more information than they would if there was no regulation
A regulatory framework and accounting standards help make financial statements more useful to users
IASB issues standards
IASB objectives:
• To develop high quality, understandable and enforceable global accounting standards
• To bring about convergence of national standards and IFRS


The *Conceptual Framework* and accounting policies
Conceptual framework and GAAP Conceptual framework is a set of theoretical principles that form a frame of reference for financial reporting
Benefits of framework:
• Used as a basis for development of accounting standards
• Financial reporting based on standardised principles
• Preparers apply the spirit and reasoning behind standards; therefore harder to avoid compliance
The IASB's *Conceptual Framework for Financial Reporting* is the international conceptual framework.
Its purpose is to:
• assist with the development of future accounting standards
• promote harmonisation
• assist national standard-setters
• assist auditors, preparers and users of financial statements
Objective of general purpose financial reporting:
• Provide useful information to existing and potential investors, lenders and other creditors
The use of judgment in accounting decisions:
• Accounting standards provide guidance on dealing with transactions
• If no standard exists, the accountant must use judgement
• *Conceptual Framework* is a useful reference point in these situations
Accounting policies:
• Principles, bases, rules, conventions and practices used in preparing financial statements
• Provide information that is relevant and faithfully represents the underlying transactions
IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*


Accounting standards and concepts
Role of accounting standards:
• Set out accounting rules companies must follow
• Applying accounting standards should give a fair presentation
Accounting standards and choice:
• Standards reduce variations in methods of accounting
• But may be inflexible/inappropriate in some circumstances
Accounting concepts:
• Going concern (underlying assumption)
• Accruals
• Substance over form
Fundamental qualitative characteristics of financial information: relevance and faithful representation
Enhancing qualitative characteristics of financial information: comparability; verifiability; timeliness; and understandability
International harmonisation
• Aim to have one set of global accounting standards
• Number of barriers, but many advantages
• EU adopted IFRS from 2005
• IASB and US FASB have carried out important joint projects to harmonise accounting standards



The financial reporting environment: Module summary diagrams

BEFORE YOU BEGIN

If you have studied these topics before, you may wonder whether you need to study this module in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the module to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the module you can find the information, and you will also find a commentary at the back of the Study Guide.

1 Identify three differences between financial and management accounts. (Section 1)

2 What is the purpose of financial reporting? (Section 2)

3 What is a reporting entity? (Section 3)

4 Who are the main user groups of financial statements, and why are they interested in financial information? (Section 4.2)

5 What is GAAP? (Section 5.2)

6 Which of the following are advantages of accounting regulation?

I. increased public confidence in financial statements
II. enhanced comparability between financial statements
III. the development of rules which are applicable to all entities
IV. the disclosure of more useful information than if there were no regulations

A I and IV only
B I, II and IV only
C II, III and IV only
D I, II, III and IV (Section 5.3)

7 What is the IASB and what are its objectives? (Sections 6.1 and 6.3)

8 What is the IFRS Advisory Council and what is its purpose? (Section 6.4)

9 What is the IFRS Interpretations Committee and what is its purpose? (Section 6.4)

10 What is a conceptual framework? (Section 7.1)

11 What are the problems associated with **not** having a conceptual framework? (Section 7.2)

12 Which of the following are objectives of the IASB's *Conceptual Framework*?

I. to promote consistency between IFRS
II. to assist in the development of new IFRS
III. to assist auditors in forming their opinion
IV. to assist national standard-setters in setting national standards

A I and II only
B III and IV only
C I, II and IV only
D I, II, III and IV (Section 8.2)

13 What is the objective of general purpose financial reporting according to the IASB's *Conceptual Framework*? (Section 9)

14 What are accounting policies? (Section 12)

15 How is a change in accounting policy accounted for? (Section 13.3)

16 How is a change in accounting estimate accounted for? (Section 13.4)

17 What is the underlying assumption in preparing financial statements according to the *Conceptual Framework*? (Section 16.1)

18 Explain the concept of 'substance over form' and provide an example of its application. (Section 16.3)

19 What are the two fundamental qualitative characteristics and the four enhancing qualitative characteristics of financial statements identified by the *Conceptual Framework*? (Section 17)

20 What makes financial information relevant? (Section 17.1)

21 Identify three barriers to the global harmonisation of accounting standards. (Section 19.2)

22 Define an asset. (Section 20.2)

23 Define a liability. (Section 20.2)

24 Define equity. (Section 20.2)

25 What criteria must be met in order for an item to be recognised in the financial statements? (Section 21)

26 Which of the following statements is/are correct?

I. All assets and liabilities must always be presented in order of liquidity.

II. A liability is always classified as non-current where the amount due is to be settled in more than 12 months.

A I only
B II only
C both I and II
D neither I nor II (Sections 23.1.1 and 23.1.2)

1 THE PURPOSE OF ACCOUNTING

LO 1.2

Section overview

- Accounting is the process of recording, analysing and summarising transactions of an entity and communicating that information to decision makers.
- A business is an entity which exists to make a profit.
- There are three main types of business entity: sole traders, partnerships and limited liability companies.
- Non-commercial undertakings such as charities, clubs and government entities may also prepare accounts.

1.1 WHAT IS ACCOUNTING?

You may have a wide understanding of what accounting and financial reporting is. Your job may be in one area or type of accounting, but you must understand the breadth of work which an accountant undertakes. In particular, you need to understand the distinction between financial accounting and management accounting.

Definition

Accounting is the process of recording, analysing and summarising transactions of a business and communicating that information to decision makers.

Renaissance scholar **Luca Pacioli** wrote the first printed explanation of double-entry bookkeeping in 1494. Double-entry bookkeeping involves entering every transaction as a **debit** in one account and a corresponding **credit** in another account, and ensuring that they balance. Pacioli's description of the method was widely influential.

The first English book on the subject was written in 1543 by John Gouge. The practice of double-entry bookkeeping has barely changed since then and is standard across the world, based upon the concept that every transaction has a dual effect expressed as debits equals credits.

The original role of the accounting function was to record financial information and this is still its main focus.

Why do businesses need to produce accounts? If a business is being run efficiently, why should it have to go through all the bother of accounting procedures in order to produce financial information?

A business needs to produce information about its activities because there are various groups of people who want or need to know that information. Later in this module we will consider the different groups of users and the type of information that is of interest to the members of each group.

1.2 FINANCIAL ACCOUNTING

Definition

Financial accounting is a method of reporting the results and financial position of a business.

It is not primarily concerned with providing information towards the more efficient running of the business. Although financial accounts are of interest to management, their principal function is to satisfy the information needs of persons not involved in running the business, in particular shareholders. Financial accounts provide **historical** information.

1.3 MANAGEMENT ACCOUNTING

The information needs of management go far beyond those of other account users. Managers have the responsibility of planning and controlling the resources of the business and for making decisions about the direction of the business both in the longer term and on a day to day basis. Therefore they need much more detailed information. They also need to **plan for the future**, for example, budgets, which predict future revenue and expenditure.

Definition

Management accounting, sometimes known as cost accounting, is a management information system which analyses data to provide information as a basis for managerial action. The concern of a management accountant is to present accounting information in the form most helpful to management.

1.4 WHAT IS A BUSINESS?

Definition

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

Businesses of whatever size or nature exist to make a profit.

There are a number of different ways of looking at a business. Some ideas are listed below.

- A business is a **commercial or industrial concern** which exists to deal in the manufacture, re-sale or supply of goods and services.
- A business is an **organisation that uses economic resources** to create goods or services which customers will buy.
- A business is an **organisation providing jobs** for people.
- A business invests **money in resources** for example, buildings, machinery, employees, in order to make even more money for its owners.

This last definition introduces the important idea of profit. Businesses vary from very small businesses for example, the local shopkeeper or plumber, to very large ones for example, IKEA, Nestlé, Unilever. However all of them want to earn profits.

Definition

Profit is the excess of revenue (income) over expenses. When expenses exceed revenue, the business is running at a loss.

One of the jobs of an accountant is to measure revenue and expenditure, and so profit.

1.5 TYPES OF BUSINESS ENTITY

There are three main types of business entity:

- sole traders;
- partnerships; and
- limited liability companies.

Sole traders are people who work for themselves. Examples may include the local shopkeeper, a plumber and a hairdresser. The term sole trader refers to the **ownership** of the business – sole traders can have employees.

Partnerships occur when **two or more** people decide to run a business together. Examples may include an accountancy practice, a medical practice and a legal practice.

Limited liability companies are incorporated to take advantage of 'limited liability' for their owners (shareholders). This means that, unlike sole traders and partners, who are **personally responsible** for the amounts owed by their business, the shareholders of a limited liability company are only responsible for the **amount unpaid on their shares**. This means that if the shareholders have purchased shares costing $100 but have only paid $40 to date, they would have to contribute the remaining $60 towards paying the company's debts.

Generally, **in law** sole traders and partnerships are not separate entities from their owners. This is true in many jurisdictions, for example, Australia, the UK, India, New Zealand, China, Japan and Germany. In the US, however, partnerships do have separate legal personality but the partners are wholly liable for debts of the partnership. In all cases, however, a limited liability company is legally a separate entity from its owners and it can issue contracts in the company's name.

For **accounting purposes**, all three entities are treated as **separate** from their owners. This is called the **business entity concept**. The methods of accounting used in all three types of business entities will be very similar, although will tend to become more complex the larger the entity.

1.5.1 NON-COMMERCIAL UNDERTAKINGS

It is not only businesses that need to prepare financial statements. **Charities and clubs**, for example, may need to prepare financial statements every year. Financial statements also need to be prepared for **government** organisations (public sector organisations such as hospitals and local councils).

2 NATURE, PRINCIPLES AND SCOPE OF FINANCIAL REPORTING

LO 1.1

Section overview

- **Financial reporting** is the process of classifying, recording and presenting financial data in accordance with generally established concepts and principles.

2.1 WHAT IS FINANCIAL REPORTING?

Financial data is the name given to the record of actual transactions carried out by a business for example, sales of goods, purchases of goods, payment of expenses. These transactions are analysed according to type, recorded in ledger accounts and summarised in the financial statements.

Financial reporting is the process of reporting the results and financial position of a business or 'reporting entity'. Although financial accounts are of interest to management, their principal function is to provide historical information in order to satisfy the information needs of external users such as shareholders. Financial accounting is not primarily concerned with providing information towards the more efficient running of the business – this is the function of a separate branch of accounting, known as 'management accounting'.

2.2 GENERAL PURPOSE FINANCIAL REPORTING

Accounting Standards (and company law in some countries) prescribe that a company should **produce accounts to be presented to the owners (shareholders)**. Accounts must normally be presented at least annually, and there are usually detailed regulations on what they must contain and the form they must take. For example, in Australia, the form and content of company financial statements is regulated by the *Corporations Act 2001* and by Australian Accounting Standards, which are equivalent to **International Financial Reporting Standards (IFRS)** issued by the **International Accounting Standards Board (IASB)**.

Large listed companies (sometimes known as public companies) are required to **publish** their annual financial statements. A listed company is a company whose shares or debt instruments are publicly traded on a stock exchange. Published financial statements may be printed or made available on the company's website. In some countries, for example, the UK, **all** limited companies must 'publish' their annual accounts by filing them with the Registrar of Companies. They are then available to members of the public.

These 'published' annual financial statements are **general purpose financial statements** or **general purpose financial reports**. They contain information which may be useful to a **wide range of users external to the company**. They are distinct from **special purpose financial reports** which are prepared for a particular group of users and for a particular purpose. Share prospectuses and tax computations are examples of special purpose financial reports.

Some users of published financial statements are able to obtain additional information. For example, owners or lenders may be able to request forecasts and budgets and members of the public have access to information in the financial press or on the internet. However, generally, most external users **have to rely on the annual financial statements** as their major source of financial information.

Financial statements do not include directors' reports, statements by the chairman, management commentaries or environmental and social reports, although these may be included in the published annual report of a large listed company (see Module 2).

2.3 LIMITATIONS OF FINANCIAL REPORTING

General purpose financial statements cannot possibly provide all the information that external users might need about a company or business. Users may also need to consider information from other sources, such as general economic conditions, the political situation and conditions in the industry in which the business operates.

There are other inherent limitations of the financial accounting and reporting process.

- Financial statements are based on **estimates** and **judgments**. For example, management must estimate the useful lives of assets and the likelihood that amounts receivable will actually be received. Preparing financial statements and reports involves **classifying** and **aggregating** (adding together) information about transactions and other events. It also involves **allocating** the effects of continuous business transactions over separate accounting periods.
- Financial statements are based on **historical information**. They **do not reflect future events or transactions** that may affect the business and the way that it operates. Users of the financial statements normally need to predict how well a business will perform in future and to understand the factors which may affect its future performance.
- Financial statements largely record only the **financial effects** of transactions and events. For example, intangible assets such as the technical expertise of the workforce may have a very significant effect on a company's performance. However, these 'assets' are not recognised because they cannot be reliably valued at a monetary amount. Financial statements **do not include non-financial information** such as discussion of the risks and uncertainties that a business faces, or a description of its effect on the natural environment.

Question 1: Financial reporting

Financial reporting means the financial statements produced only by a large listed company.

Is this statement correct?

A yes

B no

(The answer is at the end of the module.)

3 THE REPORTING ENTITY

LO 1.3

Section overview

- A **reporting entity** is an entity whose general purpose financial statements are relied upon by other parties or users of the accounts.

A reporting entity is defined in Australia as 'an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries'. Only certain regulations will apply to the reporting entity.

The 'reporting entity' concept is not, however, one that is currently adopted outside Australia and at present International standard-setters have no official equivalent definition. Internationally therefore, a reporting entity is taken quite simply to be an entity, or group of entities, which prepare accounts. A project is currently underway to develop an international 'reporting entity' concept.

4 USERS' AND SHAREHOLDERS' NEEDS

LO 1.4

Section overview

- There are various groups of people who need information about the activities of a business.

4.1 THE NEED FOR FINANCIAL STATEMENTS

The purpose of financial statements is to provide useful information about the **financial position, performance** and **changes in financial position** of an entity to a wide range of users.

Users need this information for two reasons:

1. to **make economic decisions**; and
2. to **assess the stewardship of management**.

4.1.1 MAKING ECONOMIC DECISIONS

The types of economic decisions for which financial statements are likely to be used include the following:

- decisions to buy, hold or sell equity investments;
- assessment of management stewardship and accountability;
- assessment of the entity's ability to pay employees;
- assessment of the security of amounts lent to the entity;
- determination of taxation policies;
- determination of distributable profits and dividends;
- inclusion in national income statistics; and
- regulation of the activities of entities.

4.1.2 STEWARDSHIP

Stewardship is relevant where an organisation is managed by people other than its owners. For example, the owners of a listed company appoint directors to run the company on their behalf, who are then accountable for the company's resources. They must use these resources efficiently and effectively to produce profits or other benefits for the owners. Owners need to be able to assess the performance of the directors so that they can decide whether to reappoint them or remove them and how much they should be paid.

4.2 USERS OF FINANCIAL STATEMENTS AND ACCOUNTING INFORMATION

A business should produce information about its activities because there are various groups of people who want or need to know that information.

Large businesses are of interest to a greater variety of people and so we will consider the case of a listed company, whose shares can be purchased and sold on a stock exchange.

The following people are likely to be interested in financial information about a company with listed shares.

- **Managers of the company** appointed by the company's owners to supervise the day-to-day activities of the company. They need information about the company's financial situation as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to make effective decisions.
- **Shareholders of the company**, that is, the company's owners, want to assess how well the management is performing. They want to know how profitable the company's operations are and how much profit they can afford to withdraw from the business for their own use.
- **Trade contacts** include suppliers who provide goods to the company on credit and customers who purchase the goods or services provided by the company. **Suppliers** want to know about the company's ability to pay its debts; **customers** need to know that the company is a secure source of supply and is in no danger of having to close down.
- **Providers of finance to the company** might include a bank which allows the company to operate an overdraft, or provides longer-term finance by granting a loan. The bank wants to ensure that the company is able to keep up interest payments, and eventually to repay the amounts advanced.
- **The taxation authorities** want to know about business profits in order to assess the tax payable by the company, including sales taxes, for example, Goods and Services Tax or Value Added Tax.
- **Employees of the company** should have a right to information about the company's financial situation, because their future careers and the size of their wages and salaries depend on it.
- **Financial analysts and advisers** need information for their clients or audience. As examples, stockbrokers need information to advise investors; credit agencies want information to advise potential suppliers of goods to the company; and journalists need information for their reading public.
- **Government and their agencies** are interested in the allocation of resources and therefore in the activities of business entities. They also require information in order to provide a basis for national statistics.
- **The public**. Companies affect members of the public in a variety of ways. They may make a substantial contribution to a local economy by providing employment and using local suppliers. Another important factor is the effect of an entity on the environment as an example in relation to pollution.

Accounting information is summarised in financial statements to satisfy the **information needs** of these different groups. These information needs will differ between each user group and not all will be equally satisfied.

4.3 NEEDS OF DIFFERENT USERS

Managers of a business need the most information, to help them make their planning and control decisions. They clearly have 'special' access to information about the business, because they are able to demand whatever internally produced statements they require. When managers want a large amount of information about the costs and profitability of individual products, or different parts of their business, they can obtain it through a system of cost and management accounting rather than rely on the financial accounts.

Shareholders, providers of finance and financial analysts and advisers need information that helps them to make decisions: whether to buy, hold or sell their investment in a business or whether to lend money to it. Unlike managers, these users are **external** to the business. Therefore they normally **have to rely on the published financial statements** to provide them with the information that they need.

For this reason, in most developed countries, including Australia, published **financial statements are primarily prepared to meet the information needs of existing and potential investors and lenders** and their advisors.

Question 2: Information needs

Which of the following items in the financial statements of a company would be of particular interest to a customer?

A operating profit
B retained earnings
C dividend payments
D directors' remuneration

(The answer is at the end of the module.)

5 THE NEED FOR A REGULATORY FRAMEWORK

LOs 1.1, 1.3

Section overview

- The regulatory framework ensures that general purpose financial reporting produces relevant and reliable information and therefore meets the needs of shareholders, lenders and other users.
- Generally accepted accounting principles (GAAP) signifies all the rules, from whatever source, that govern accounting. GAAP includes accounting standards (IFRS and national standards), national company law, and local stock exchange requirements.
- Regulation of companies and their published financial information can vary significantly in different countries throughout the world.

5.1 SUBJECT OUTLINE

The regulatory framework consists of accounting rules and company law. These ensure that general purpose financial reporting provides useful information that meets the needs of shareholders, lenders and other users.

The International Accounting Standards Board (IASB) develops and issues International Financial Reporting Standards (IFRS). As IFRS have no jurisdiction, and the IASB has no authority to impose accounting standards, individual countries draw up their own accounting regulations. In practice, national governments often adopt IFRS and then adapt them to operate together with local laws and regulations as necessary.

5.2 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

Generally accepted accounting principles (GAAP) signifies all the rules, from whatever source, which govern accounting. The concept is applicable globally.

In individual countries GAAP is seen primarily as a combination of:

- national company law;
- national accounting standards; and
- local stock exchange requirements.

Although these sources are the basis for the GAAP of individual countries, the concept also includes **sources** such as:

- IFRS; and
- accounting requirements of other countries.

In many countries, GAAP does not have any statutory or regulatory authority or definition. There are different views of GAAP in different countries. The IASB convergence program seeks to reduce these differences.

GAAP can be based on legislation and accounting standards that are either:

- prescriptive/rules-based; or
- principles-based.

The US operates a **prescriptive** system, where standards are very detailed, attempting to cover all eventualities. Accounts which do not comply in all details are presumed to be misleading. This has the advantage of clear requirements which can be generally understood and it removes any element of judgment.

In general, international financial reporting standards (IFRS) are **principles-based.** They do not specify all the details but seek to obtain adherence to the 'spirit' of the regulations. This leaves room for some element of professional judgment. It also makes it harder for entities to avoid applying a standard as the terms of reference are broader. (We will be discussing the differences between rules-based standards and principles-based standards in more detail later in this module.)

5.2.1 INDIVIDUAL JUDGMENT

Financial statements are prepared on the basis of a number of **fundamental accounting assumptions and conventions**. Many figures in financial statements are derived from the application of judgment in putting these assumptions into practice.

It is clear that different people exercising their judgment on the same facts can arrive at very different conclusions.

Question 3: Judgment

An accountancy training firm has an excellent reputation amongst students and employers. How would you value this? The firm may have relatively little in the form of tangible assets that you can touch, perhaps a building, desks and chairs. If you simply drew up a statement of financial position showing the cost of the assets owned, then the business would not seem to be worth much, yet its income earning potential might be high. This is true of many service organisations where the people are among the most valuable assets. Here judgment must be used in order to reach a valuation for the business, although one person's judgment may lead to a very different valuation from another person's.

Required

Can you think of any other areas where judgment would have to be used in preparing financial statements?

(The answer is at the end of the module.)

5.3 ADVANTAGES AND DISADVANTAGES OF REGULATION

The key benefit of accounting regulation is that it requires organisations to prepare financial statements on a **consistent** basis. This is useful for the users of financial statements that were identified earlier in this module. For example, an investor wishing to purchase shares in a company is able to **compare that company's performance with another**, as their financial statements should have been prepared on the same basis.

Other **advantages of regulation** include:

- The existence of accounting rules **reduces variations** in the way financial statements are prepared. Without regulation it would be possible for preparers to adopt whatever accounting treatments they choose and to vary these from year to year in order to present the company's profit figure and net assets in as favourable a light as possible. In addition, transactions and businesses have become increasingly complex. There are many legitimate ways to present, measure and disclose items such as complex financial instruments, but the accounting treatment of these items needs to be comparable between different entities and over time.
- Regulation means there will be rules as to what should be disclosed which improves the **quality of information** produced. For example, IAS 1 *Presentation of Financial Statements* requires companies to disclose the accounting policies that they have followed, so that users can understand the judgments that preparers have made in arriving at the amounts in the financial statements. Financial statements must also include supporting notes which analyse and explain the main line items in the financial statements. Specific information that must be disclosed is set out in accounting standards and (in some cases) companies legislation.
- The existence of regulation is likely to ensure that companies disclose **more information** about their business activities and financial results than they may have done in the absence of such regulation. There is an argument that companies resist disclosing information unless they are required to do so. There are costs associated with providing financial information. Without regulation, management is likely to be unwilling to deliver 'bad news' to investors, or to provide information that could be used by competitors.
- Regulation of companies listed on stock exchanges means there are strict requirements in terms of reporting and disclosure and this is likely to **protect investors**. In many countries, such as Australia, the US and the UK, systems of accounting regulation were originally developed as a response to high-profile company failures and frauds in which many investors lost their savings.
- A strong system of regulation will **increase public confidence** in the published financial statements of companies. This is particularly important since there have recently been a number of high profile corporate failures contributed to by inappropriate accounting.
- Some users of financial statements (for example, major corporate investors and lenders) have the power to demand the information that they need. Other users (for example, small investors and individual members of the public) have not. Regulation protects those less powerful individuals and organisations and can therefore be seen as a **social good**.

Disadvantages of regulation include:

- Strict regulation could mean a **lack of flexibility** for some businesses. Sometimes companies have differing business environments. These companies may have to adopt accounting treatments that do not properly reflect their financial performance and position and actually lessen the quality of the information that they provide. In this situation, it may be impossible for users to make meaningful comparisons between companies.
- Companies may incur **high costs** in complying with the regulatory rules. The cost of providing the information required may outweigh the benefits of that information. This is particularly relevant where small companies have to comply with either US regulations or the full set of International Accounting Standards (known as 'full IFRS'). Both the US and 'full IFRS' systems were designed primarily to meet the accounting needs of multinational organisations and to protect large institutional investors in those organisations. They therefore include standards on topics such as financial instruments, earnings per share, operating segment disclosure and share-based payment transactions, which are, in most cases, not relevant to smaller entities. The IASB has now developed a special standard for small and medium entities (the IFRS for SMEs) as an alternative to 'full IFRS'. This standard omits certain topics and simplifies others in order to lessen the regulatory burden on smaller entities.

- Detailed rules and regulations may mean that companies spend a great deal of time '**box-ticking**' without considering the spirit of the regulation they are complying with. Information is provided because it is required, even though it is of little value. The problem can be particularly acute where preparers are required to make specific narrative disclosures, for example, about corporate governance or future prospects for the business. Users frequently complain about 'boiler plate' disclosures: general statements that could apply to any company and tell the reader nothing.
- Regulation leads to financial statements that contain **too much information** and this can obscure the overall picture that they present. The length and volume of company annual reports is steadily growing as the result of new accounting requirements. Many commentators believe that published financial statements have become too complex for anybody other than a financial reporting expert to understand.

Question 4: Creative accounting

Creative accounting is the name given to accounting treatments which comply with all applicable accounting regulations but which have been deliberately manipulated to give a biased impression of a company's performance or financial position. From the 1990s onwards, new or improved accounting standards were developed to prevent most of these practices.

Required

Briefly describe two possible methods of 'creative accounting'.

(The answer is at the end of the module.)

5.4 VARIATIONS IN REGULATORY REGIMES

Regulation of companies and their published financial information can vary significantly in different countries throughout the world. There are many reasons for these differences. In some cases it is due to differences in company structures, local culture and ownership patterns of companies.

5.4.1 COMPANY STRUCTURE AND OWNERSHIP

A country where the majority of companies are **family owned** with few, if any, external shareholders outside the family will need far less regulation than a country which is dominated by large **multinational corporations** with large numbers of shareholders, who have no connection to the business. Much of the regulation in the latter case would be to ensure that companies are **acting in the best interests** of shareholders. In many family companies, the shareholders and directors are the same family members, so they will already be acting in the best interests of the shareholders and will be concerned about the long-term future of the business.

5.4.2 LEVEL OF DEVELOPMENT

The level of development of a nation also has an impact on its level of regulation. **Developing countries** are further behind in the process of setting standards and establishing regulatory regimes than industrialised nations.

East Timor, a tiny nation in both territory and population, was officially accepted into the United Nations as a sovereign state in 2002 after a long-running battle for independence from Indonesia. A poor nation, it is establishing systems for long-term political and economic stability but is still struggling with the problems facing many developing nations. It is party to international conventions and standards (including IFRS), but lags behind in implementation. Cambodia is another example of a Southeast Asian developing nation where conflict and resulting economic instability means it is still 'catching up' with more industrialised nations in terms of regulation adoption and implementation. Fiji, one of the largest and economically strongest Pacific island nations, was suspended from both the Pacific Island Forum and the Commonwealth of Nations during 2009, with both suspensions currently remaining in force. Fiji's political upheaval means standard-setting and regulation is of low importance.

5.4.3 DIFFERENT PURPOSES OF FINANCIAL REPORTING

In some countries the purpose of preparing financial statements is solely for **tax assessment**, and therefore the accounting rules are often the same as the tax rules. In other countries, financial statements exist to provide information for **investor decision-making**. This will have an impact on the type of regulatory system in place.

5.4.4 DIFFERENT USER GROUPS

Countries have different ideas about who the relevant user groups are and their respective importance. User groups may include financiers, management, investors, creditors, customers, employees, the government and the general public. In some countries **investor and creditor** groups are given prominence, while in others **employees** enjoy a higher profile.

6 THE IFRS FOUNDATION AND THE IASB

LOs 1.1, 1.4, 1.5

Section overview

- The International regulatory framework consists of:
  - The International Financial Reporting Standards Foundation (IFRS Foundation);
  - The International Accounting Standards Board (IASB);
  - The International Financial Reporting Standards Advisory Council; and
  - The International Financial Reporting Standards Interpretations Committee.
- IFRS are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.

6.1 SUBJECT OUTLINE

The **IFRS Foundation** is an independent, not-for-profit private sector organisation working in the public interest. It was founded in March 2001 as the International Accounting Standards Committee (IASC) Foundation and is the parent entity of the IASB. The IFRS Foundation publishes and promotes IFRS. Its mission statement is 'to develop IFRS Standards that bring transparency, accountability and efficiency to financial markets around the world'.

The governance and oversight of the IFRS Foundation and its standard-setting bodies rests with the **Trustees**. They are also responsible for promoting IFRS and securing the organisation's funding. The Trustees are appointed for a renewable term of three years and must have an understanding of the issues relevant to the setting and development of IFRS but are not involved in a technical capacity. Six of the Trustees must be selected from the Asia/Oceania region, six from Europe, six from North America, one from Africa, one from South America and two from the rest of the world.

A **Monitoring Board** (established in 2009) provides a **formal link between the Trustees and public capital market authorities**. The Monitoring Board participates in the process for appointing Trustees and approves their appointment. It also advises the Trustees, who are required to report to it annually, and review their work. The Monitoring Board has six members drawn from the European Commission (EC), the International Organization of Securities Commissions (IOSCO), the US Securities and Exchange Commission (SEC) and other regulatory bodies.

The **International Accounting Standards Board** is the standard-setting body and is an independent, privately-funded accounting standard setter based in London. It is a part of the International regulatory framework, reporting to the IFRS Foundation.

From April 2001 the IASB assumed accounting standard setting responsibilities from its predecessor body, the International Accounting Standards Committee (IASC).

The IASB has an important role to play in the regulation of financial information as it is responsible for issuing IFRS, which are then adopted for use in many different jurisdictions. Since 2001, almost 120 countries have required or permitted the use of IFRS in preparing financial information which makes the IASB the most important accounting body worldwide. Most of the remaining major economies, other than the US, have timelines in place for the move from national accounting standards to convergence with IFRS in the near future.

6.2 THE COMPOSITION OF THE IASB

The IASB is an independent group of experts with recent relevant practical experience. Its members are selected so that there is a mix of auditors, preparers, users and academics.

The 12 members of the IASB come from many different countries and have a diverse range of backgrounds. There are currently three members from the Asia/Oceania region; three members from Europe; two members from North America; one member from Africa; one member from South America; and two members appointed from any area, subject to maintaining overall geographical balance.

The IASB aims to be collaborative in its development of standards by engaging with the worldwide standard setting community as well as investors, regulators, business leaders and the global accountancy profession.

6.3 OBJECTIVES OF THE IFRS FOUNDATION AND THE IASB

The formal objectives of the IFRS Foundation and IASB are:

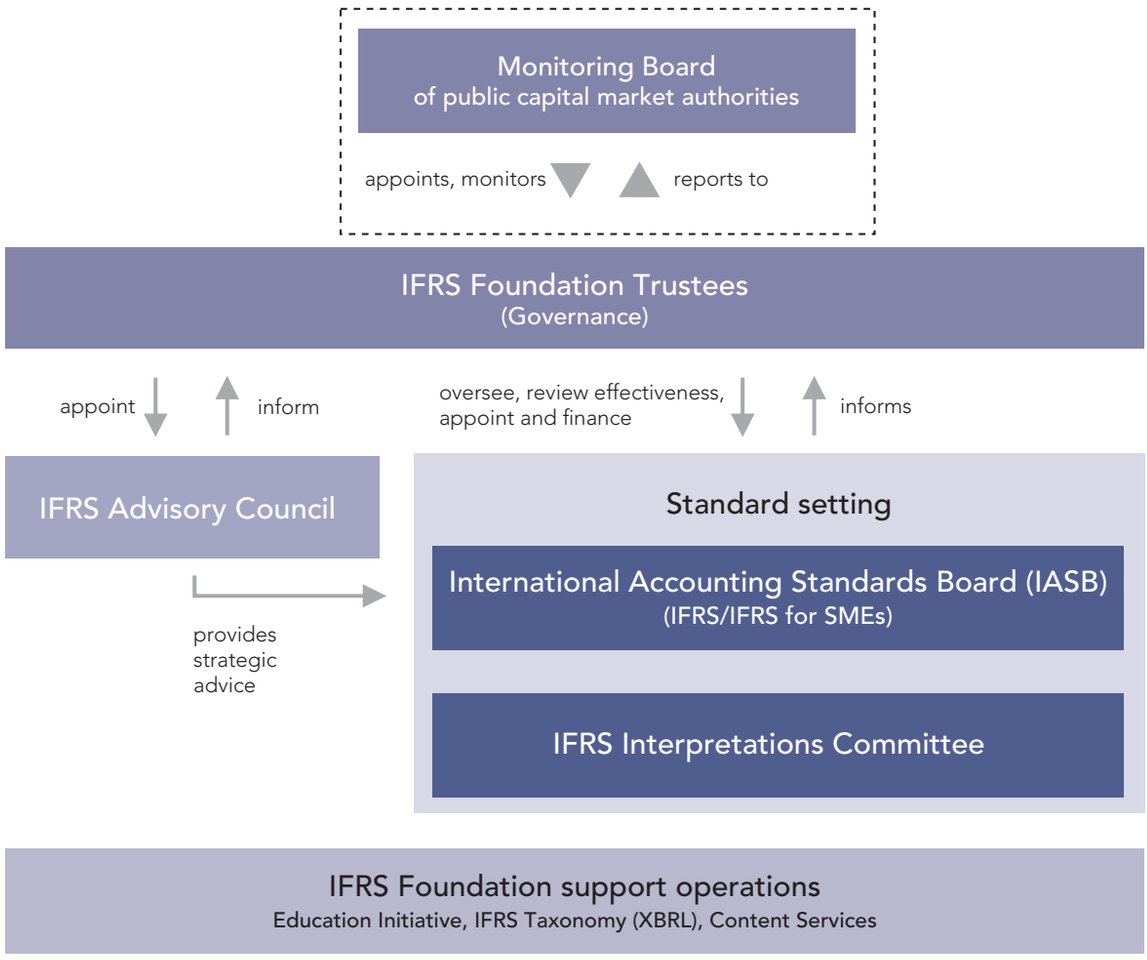
- To develop, in the public interest, a single set of high quality, understandable, enforceable and **globally accepted financial reporting standards** based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information to make economic decisions.
- To promote the use and **rigorous application** of those standards.
- To take account of the needs of a range of sizes and types of entities in diverse economic settings.
- To **promote** and **facilitate adoption** of International Financial Reporting Standards (IFRS), being the standards and interpretations issued through the IASB, through the convergence of national accounting standards and IFRSs.

6.4 STRUCTURE OF THE IFRS FOUNDATION

The structure of the IFRS Foundation has the following main features:

- The IFRS Foundation oversees two main areas – the standard-setting process and the IFRS Advisory Council (previously known as the Standards Advisory Council).
- The standard-setting process consists of two bodies, the **IASB** (as discussed above) and the **IFRS Interpretations Committee**. The IASB has the sole responsibility for setting international financial reporting standards.
- The **IFRS Interpretations Committee** (previously known as the International Financial Reporting Interpretations Committee or IFRIC) comprises 14 voting members drawn from a variety of countries and professional backgrounds. The IFRS Interpretations Committee provides timely guidance on the application and interpretation of IFRS. It deals with newly identified financial reporting issues not specifically addressed in IFRS, or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.
- The **IFRS Advisory Council** (previously the Standards Advisory Council) is the formal advisory body to the IASB and Trustees of the IFRS Foundation. It is comprised of a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups that are affected by and interested in the IASB's work. Members of the Advisory Council are appointed by the Trustees. It meets three times a year to advise the IASB on a range of issues including the IASB's agenda and work program.

The structure of the IFRS Foundation can be illustrated as follows:



6.5 THE STANDARD SETTING PROCESS

IFRS are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world. The process of developing an accounting standard has six stages as follows:

Step 1 **Setting the agenda.** The IASB evaluates the merits of adding a potential item to its agenda mainly by reference to the needs of investors.

The IASB considers:

- the relevance to users of the information and the reliability of information that could be provided;
- whether existing guidance is available;
- the possibility of increasing convergence;
- the quality of the standard to be developed; and
- resource constraints.

The IFRS Advisory Council and the IFRS Interpretations Committee, other standard-setters and other interested parties may have made comments on accounting issues that could become potential agenda items.

Step 2 **Planning the project.** When adding an item to its work agenda, the IASB considers whether to conduct the project alone or jointly with another standard setter. A working group is usually formed at this stage and the project plan is developed.

Step 3 **Developing and publishing the discussion paper.** It is not mandatory for the IASB to issue a discussion paper in the development of a standard, but it is usual practice where there is a major new topic being developed and the IASB wish to set out their position and invite comments at an early stage in the process. Typically, a discussion paper includes:

- a comprehensive overview of the issue;
- possible approaches in addressing the issue;
- the preliminary views of its authors or the IASB; and
- an invitation to comment.

Step 4 **Developing and publishing the exposure draft.** This is a mandatory step in the due process. Regardless of whether a discussion paper has been published, the exposure draft is the IASB's main means of consulting the public on the proposed standard. The exposure draft sets out the proposed standard in detail. The development of the exposure draft begins with the IASB considering the following:

- issues on the basis of staff research and recommendations;
- comments received on the discussion paper (if one was published); and
- suggestions made by the IFRS Advisory Council, working groups, other standard-setters and public meetings where the proposed standard was discussed.

Once the exposure draft has been published the IASB again invites comments.

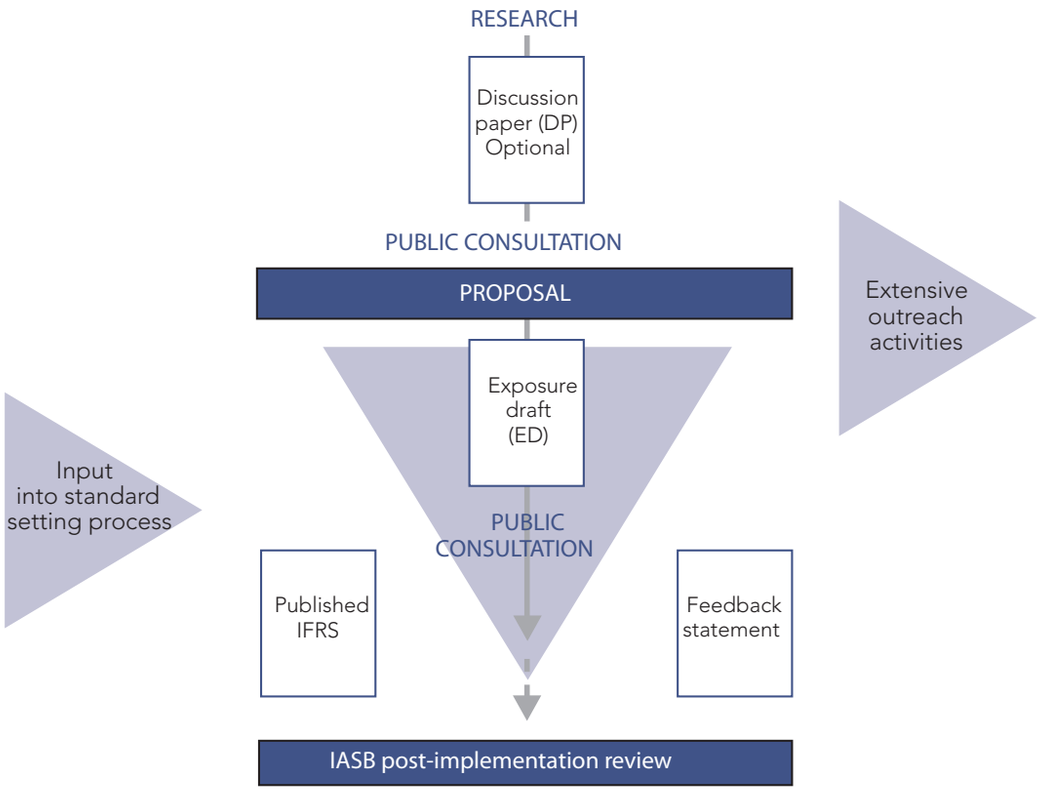
Step 5 **Developing and publishing the standard.** The development occurs at IASB meetings when the IASB considers the comments received on the exposure draft. The IASB must then consider whether a second exposure draft should be published. The IASB needs to:

- identify substantial issues that emerged during the comment period on the exposure draft that it had not previously considered;
- assess the evidence that has been considered;
- evaluate whether it has sufficiently understood the issues and obtained the views of constituents; and
- consider whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions.

If the IASB decides that the exposure draft should be republished then the same process should be followed as for the first exposure draft. Once the IASB is satisfied that the issues raised have been dealt with, the IFRS is drafted.

Step 6 **After the standard is issued.** After an IFRS is issued, IASB holds regular meetings with interested parties, including other standard-setting bodies, to help understand unanticipated issues related to the practical implementation and potential impact of its proposals. If there are concerns about the quality of the standard from the IFRS Advisory Council, the IFRS Interpretations Committee, standard-setters and constituents, then the issue may be added to the IASB agenda and the process reverts back to Step 1. Post-implementation reviews are carried out for each new standard, generally after the requirements have been applied for two years internationally.

The standard setting process can be illustrated in the figure below:



6.6 CONSULTATION WITH NATIONAL STANDARD-SETTERS

The development of an IFRS involves an **open, public process of debating technical issues** and evaluating input sought through several mechanisms. Opportunities for interested parties to participate in the development of IFRS would include, depending on the nature of the project:

- participation in the development of views as a member of the **IFRS Advisory Council**;
- participation in **advisory groups**;
- submission of a **comment letter** in response to a **discussion document**;
- submission of a **comment letter** in response to an **Exposure Draft**;
- participation in **public hearings**; and/or
- participation **in field visits and field tests**.

The IASB publishes an annual report on its activities during the past year and priorities for next year. This report provides a basis and opportunity for comment by interested parties. In addition, it also undertakes a public consultation on its future technical agenda every three years. The first of these public consultations took place in the second half of 2011 and the second public consultation was in August 2015.

The IASB reports on its technical projects on its website. It also publishes a report on IASB decisions immediately after each IASB meeting in its newsletter *IASB Update*.

6.7 THE NEED FOR INTERNATIONAL STANDARDS

Although the predecessor organisation of the IFRS Foundation was set up in the 1970s, the development of International standards has grown in importance in the last 10 years. As business and commerce became more global in nature, many interested parties began to understand the need for a common set of accounting standards. Until that point, many multinational companies prepared financial statements under a variety of GAAPs, which was costly. This also had an impact on the auditors of those financial statements and current and future investors. Companies with stock exchange listings in more than one jurisdiction had to prepare different sets of financial statements for each jurisdiction which was viewed as inefficient.

The original International Accounting Standards were deliberately drafted to be flexible and to allow choices. From the 1990s onwards it became increasingly clear that it was not enough to have a set of international standards with which most countries could comply. These standards had to be sufficiently **rigorous** to be **acceptable to all stock exchanges**, including those in the US.

The starting point for the rapid change of the last few years was the acceptance of international accounting standards for cross border listings by the International Organisation of Securities Commissions (IOSCO). International standards gained more prominence when the European Union decided that from 2005, the consolidated financial statements of companies in the member states would be prepared under international standards. IFRS became the global standards that were needed and since then many countries, including Australia and South Africa, have adopted IFRS as their national standards or have a program in place to adopt international standards in the near future.

6.7.1 BENEFITS OF HARMONISATION

There are several **general benefits of harmonisation**:

- **Investors and lenders**, both individual and corporate, **need to be able to compare the financial results of different companies internationally** as well as nationally in making investment decisions. Differences in accounting practice and reporting can prove to be a barrier to such cross-border analysis. Harmonisation of financial reporting **benefits investors, lenders and their advisors**, because it provides them with **better quality information** on which to base economic decisions. Users no longer have to understand several different national GAAPs or to incur the **costs** of adjusting financial statements in order to compare them with each other.
- Harmonisation **benefits the global economy**, because it makes it **removes barriers** to the **flow of capital** between countries. It is **easier for businesses to expand** into and **raise finance** in countries other than their own.
- Robust international financial reporting standards are also needed to **protect investors** and to **restore public confidence** in financial reporting following the failure of several banks (notably Lehman Brothers in 2008) and the resulting 'credit crunch' and global financial crisis. One of the actions agreed upon by the G-20 leaders (finance ministers and central bank governors from the world's largest economies), in their summit meetings after the crisis, was that the key global accounting standards bodies should work intensively towards the objective of creating a single set of high quality global standards.

A full list of countries adopting IFRS and their progress can be found on:
www.iasplus.com/en/resources/ifrs-topics

We look at the harmonisation process in more detail later in this module.

6.7.2 BARRIERS TO HARMONISATION

There are undoubtedly many barriers to full international harmonisation. Problems include the following:

- **Different purposes of financial reporting**. In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.
- **Different legal systems**. These may prevent the development of certain accounting practices and restrict the options available.
- **Different user groups**. Countries have different ideas about who are the relevant user groups and their respective importance. In the US investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.
- **Needs of developing countries**. Developing countries are clearly behind in the standard-setting process and they need to develop the basic standards and principles already in place in most developed countries.
- **Nationalism** is demonstrated in an unwillingness to accept another country's standard.
- **Cultural differences** result in objectives for accounting systems differing from country to country.

- **Unique circumstances**. Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example, hyperinflation, civil war, currency restriction and so on.
- **The lack of strong accountancy bodies**. Many countries do not have strong independent accountancy or business bodies which would press for better standards and greater harmonisation.

These are difficult problems to overcome, and yet attempts are being made continually to do so. We must therefore consider what the perceived advantages of harmonisation are, which justify so much effort.

6.8 BENEFITS OF IFRS FOR NATIONAL JURISDICTIONS

The advantages of IFRS described above apply to individual nations. If it is possible to **compare the financial statements** of an entity in one country with those of another entity located in a different country it becomes easier to do business with overseas companies. This benefits **national economies**, as well as the global economy.

In its 2002 policy statement *International Convergence and Harmonisation Policy* the Australian Accounting Standards Board listed the following additional benefits of adopting IFRS:

- **increasing the understanding by foreign investors** of Australian financial reports;
- **reducing financial reporting costs** for Australian multinational companies and foreign companies operating in Australia and reporting elsewhere;
- facilitating more **meaningful comparisons** of the financial performance and financial position of Australian and foreign **public sector** reporting entities; and
- **improving the quality of financial reporting** in Australia to best international practice.

There are a number of further potential benefits for national jurisdictions:

- Many **developing nations** who do not have the resources to develop and implement their own national standards **can adopt IFRS** as a full set of standards. This is perhaps more relevant since the issue of the IFRS for SMEs as previously the level of detail in standards and the amount of disclosure required was a barrier to adoption of IFRS in developing countries.
- It may be easier for national governments to **control the activities of foreign multinational companies** that carry out operations within their territory. These companies would not be able to 'hide' behind foreign accounting practices which are difficult to understand.
- **Tax authorities** may find it easier to **calculate the tax liability** of investors.

Many national standard setting bodies are experiencing a change in their role as IFRS have become more important. Many standard setters no longer develop and issue their own accounting standards and instead comment on the work of the IASB, the impact of new IFRS and changes to existing IFRS on their home jurisdiction. National standard setting bodies may also undertake research on behalf of the IASB on particular projects.

6.9 OTHER INTERNATIONAL INFLUENCES

There are a number of **other international bodies** that have been involved in the recent trend of moving to IFRS. They are discussed briefly below.

6.9.1 IASB AND THE EUROPEAN COMMISSION

The European Commission (EC) has acknowledged the role of the IASB in harmonising world-wide accounting rules and EC representatives attend IASB Board meetings and have joined Steering Committees involved in setting IFRS.

The EC has also set up a committee to investigate where there are conflicts between European Union norms and International Standards so that compatibility can be achieved. In turn, the IASB has used EC Directives in its work.

From 2005, all listed entities in member states have been required to use IFRS in their consolidated financial statements.

6.9.2 UNITED NATIONS (UN)

The UN has a Commission and Centre on Transnational Reporting Corporations through which it gathers information concerning the activities and reporting of multinational companies. The UN processes are highly **political** and probably reflect the attitudes of the governments of developing countries towards multinationals. For example, there is an inter-governmental working group of 'experts' on international standards of accounting and reporting which is dominated by the non-developed countries.

6.9.3 INTERNATIONAL FEDERATION OF ACCOUNTANTS (IFAC)

The IFAC is a private sector body established in 1977 and which now consists of over 100 professional accounting bodies, including CPA Australia, from around 80 different countries. The IFAC's main objective is to coordinate the accounting profession on a global scale by issuing and establishing International Standards on auditing, management accounting, public sector accounting, ethics, education and training. The IFAC has separate committees working on these topics and also organises the World Congress of Accountants, which is held every four years.

6.9.4 ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)

The OECD was established in 1960 by the governments of 21 countries to 'achieve the highest sustainable economic growth and employment and a rising standard of living in member countries while maintaining financial stability and, thus, to contribute to the world economy'. It now has 35 member countries.

The OECD's aim is to bring together the governments of countries committed to democracy and the market economy from around the world to:

- support sustainable economic growth;
- boost employment;
- raise living standards;
- maintain financial stability;
- assist other countries' economic development; and
- contribute to growth in world trade.

The Organisation provides a setting where governments compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies.

The OECD supports the work of the IASB but also undertakes its **own research** into accounting standards via ad hoc working groups. The OECD also produces its own corporate governance principles and other publications aimed at improving financial reporting, regulation and removing corruption.

6.9.5 AUSTRALIAN ACCOUNTING STANDARDS BOARD (AASB)

The AASB is an independent accounting standard setting body based in Melbourne. The functions of the AASB under the Australian Securities and Investments Commission (ASIC) 2001 Act are:

- to develop a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards and international standards;
- to make accounting standards under section 334 of the Corporations Act 2001 for the purposes of the corporations legislation (other than the excluded provisions);
- to formulate accounting standards for other purposes;
- to participate in and contribute to the development of a single set of accounting standards for worldwide use; and
- to advance and promote the main objects of Part 12 of the Australian Securities and Investments Commission Act, with regard to the interests of Australian corporations which raise or propose to raise capital in major international financial centres.

The mission of the AASB is to:

- develop and maintain a high-quality conceptual framework for all sectors of the Australian economy;
- develop and maintain high quality accounting (i.e. financial reporting) standards for reporting entities in those sectors; and
- contribute, through thought leadership and participation, in the development of global financial reporting standards and standard-setting.

The Australian process of harmonisation with IFRS has been to issue IFRS-equivalent standards, that is, adopt the content of IFRS with minor changes made to refer to the Australian legislative environment. The audit report of a company's financial statements states that they have been prepared in compliance with IFRS.

The AASB issues standards that apply to both for-profit and not-for-profit entities. Standards issued by the International Accounting Standards Committee (IASC), the predecessor of the IASB, are designated as IAS 1, IAS 2 etc. The Australian equivalents are AASB 101, AASB 102 etc. Standards issued by the IASB are designated as IFRS 1, FRS 2 etc, and the Australian equivalents are AASB 1, AASB 2 etc.

6.10 TRUE AND FAIR VIEW/FAIR PRESENTATION

It is a requirement of national legislation in some countries that the financial statements should give a **true and fair view** of (or 'present fairly, in all material respects') the financial performance and position of the entity as at the end of the financial year. Despite this, the terms 'true and fair view' and 'present fairly, in all material respects' are not defined in accounting or auditing standards.

In some jurisdictions a company's managers may depart from any of the provisions of accounting standards if these are inconsistent with the requirement to give a true and fair view. This is commonly referred to as the 'true and fair override'. It has been treated as an important **loophole** in the law in different countries and has been the cause of much argument and dissatisfaction within the accounting profession. For example, it is not recognised in Australia, where it was removed from legislation in 1991. Australian regulators and bodies want the accounting standards (and the true and fair view being established by them) given primacy. In Australia therefore, directors are required to provide additional information in order to comply with the true and fair view, as they cannot depart from any of the provisions of the accounting standards.

6.11 THE IASB AND CURRENT ACCOUNTING STANDARDS

The IASB's predecessor body, the IASC, had issued 41 International Accounting Standards (IASs) and on 1 April 2001 the IASB adopted all of these standards and now issues its own International Financial Reporting Standards (IFRS). So far 17 new IFRS have been issued as well as the IFRS for small and medium-sized enterprises (SMEs). From now on in this Study Guide we will use the phrase 'IFRS' for all International Accounting Standards unless we are specifically discussing a particular IAS.

6.12 THE IASB AND FASB

The IASB and the **US Financial Accounting Standards Board (FASB)** have been working together since 2002 to achieve convergence of IFRS and US GAAP. Both parties set out their agreement in a Memorandum of Understanding known as the Norwalk Agreement. Their work plan was set out in a roadmap for convergence which outlined their targets over the period up to 2008 (see also later in this module).

In 2007, the US Securities and Exchange Commission (SEC) removed the necessity for a reconciliation between IFRS and US GAAP for non-US companies that were listed in the US providing their financial statements complied with IFRS. The SEC originally planned to phase in allowing all companies to use IFRS by 2014. This has not happened and the SEC are currently considering whether a single set of global accounting standards is achievable.

In 2008, and again in 2010, the Memorandum of Understanding was updated, setting out the objectives for the period to 2011 in the convergence of US GAAP and IFRS. The IASB and the FASB set a June 2011 target date for those projects deemed to be most important, leaving those with a lesser degree of importance to be dealt with later. The following projects were completed in June 2011:

- business combinations;
- consolidation;
- derecognition of financial instruments;
- fair value measurement;
- financial statement presentation;
- joint arrangements; and
- post-employment benefits.

They published a joint progress report in 2012 on progress made on financial instruments, and in 2013 they issued a high level update on the status and timeline of the remaining projects. Since this, the IASB and FASB have worked together on the following projects:

- financial instruments;
- revenue;
- leases; and
- insurance contracts.

These projects have now been completed although the pace of these projects has slowed down. The IASB has also worked with the FASB to develop a common conceptual framework. This is intended to provide a sound foundation for developing future accounting standards.

The IASB *Conceptual Framework for Financial Reporting* is discussed later in this module and you will see that FASB have withdrawn from this project. This could begin to cast doubt over the future relationship between IASB and FASB.

KEY MODULE POINTS 1

- Accounting is the process of recording, analysing and summarising transactions of a business and communicating that information to decision makers.
- A business is an entity which exists to make a profit.
- There are three main types of business entity: sole traders, partnerships and limited liability companies.
- Non-commercial undertakings such as charities and clubs may also prepare accounts.
- Financial reporting is the process of classifying, recording and presenting financial data in accordance with generally established concepts and principles.
- A reporting entity is an entity whose general purpose financial statements are relied on by users of accounts.
- There are various groups of people who need information about the activities of a business.
- The regulatory framework is the most important element in ensuring that general purpose financial reporting produces relevant and reliable information and therefore meets the needs of shareholders, lenders and other users.
- As the IASB has no power to regulate the use of IFRS, regulation takes place at a national level.
- The organisational structure for International financial reporting consists of:
  - the IFRS Foundation;
  - the IASB;
  - the IFRS Advisory Council; and
  - the IFRS Interpretations Committee.
- IFRS are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.
- There are a number of benefits of harmonisation including the facilitation of cross-border investment and financing.

QUICK REVISION QUESTIONS 1

1 What is the main aim of accounting?
- A to produce a trial balance
- B to record every financial transaction individually
- C to maintain ledger accounts for every asset and liability
- D to provide financial information to users of such information

2 Which of the following groups of users would primarily be interested in a company's annual published financial statements?
- A shareholders and suppliers
- B management and employees
- C shareholders and providers of finance
- D general public, environmental pressure groups

3 Are the following statements correct or not correct?
- The shareholder is only interested in a statement of financial prospects, that is, an indication of future progress.
- The supplier of goods on credit is only interested in a statement of financial position, that is, an indication of the current state of affairs.

	Shareholder	Supplier
A	correct	correct
B	correct	not correct
C	not correct	correct
D	not correct	not correct

4 Which of the following statements concerning the International Accounting Standards Board is correct?
- I. It develops and ultimately issues International Financial Reporting Standards (IFRSs).
- II. The IASB is accountable to the International Accounting Standards Committee (IASC).

- A I only
- B II only
- C both I and II
- D neither I nor II

5 Which of the following statements is correct?
- A The IASB appoints the Trustees of the IFRS Foundation.
- B The IFRS Foundation develops and issues Interpretations.
- C The IFRS Interpretations Committee oversees the work of the IFRS Foundation.
- D The IFRS Advisory Council assists and advises the IASB in the process of developing IFRSs.

6 Which of these statements are correct?
- I. The IASB has the objective of enforcing IFRS.
- II. The IASB is responsible for developing and issuing IFRS.

- A I only
- B II only
- C both I and II
- D neither I nor II

7 Which committee of the IASB provides guidance on the application of IFRS?
- A IFRS Foundation
- B IFRS Advisory Council
- C IFRS Interpretations Committee
- D International Accounting Standards Committee

8 What is the correct definition of GAAP?
- A national accounting standards and company law
- B national accounting standards, stock exchange rules and company law
- C international accounting standards, company law and stock exchange rules
- D national accounting standards, international accounting standards, stock exchange rules and company law

9 Which of the following is an advantage of regulation of company financial statements?
- A lower costs of producing financial information
- B higher quality financial information is produced
- C more financial information available for competitors
- D less disclosure of a company's activities in financial statements

10 What is the correct order for the process of issuing a new IFRS by the IASB?
- A Discussion Paper, Standard
- B Exposure Draft, Discussion Paper, Review
- C Exposure Draft, Discussion Paper, Standard
- D Discussion Paper, Exposure Draft, Standard

7 CONCEPTUAL FRAMEWORK AND GAAP

LO 1.6

Section overview

- A conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.
- There are advantages and disadvantages to having a conceptual framework.

7.1 THE SEARCH FOR A CONCEPTUAL FRAMEWORK

A **conceptual framework** is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore, a conceptual framework forms the **theoretical basis** for determining which events should be accounted for, how they should be measured and how they should be communicated to the user.

7.2 THE NEED FOR A CONCEPTUAL FRAMEWORK

Definition

A conceptual framework is a coherent system of interrelated objectives and fundamental concepts that prescribes the nature, function and limits of financial accounting and reporting. (FASB)

A conceptual framework is a coherent system of concepts that flow from an objective. The objective of financial reporting is the foundation of the framework. The other concepts provide guidance on identifying the boundaries of financial reporting, selecting the transactions, other events and circumstances to be represented; how they should be recognised and measured (or disclosed); and how they should be summarised and communicated in financial reports. (IASB: *Exposure Draft of an Improved Conceptual Framework for Financial Reporting,* 2008)

A conceptual framework is an important part of the financial reporting system as it underpins the development of accounting standards and sets out the basis of recognition of items in the financial statements such as assets, liabilities, income and expenses. It provides the basis for the **development of new accounting standards** and the **evaluation of those already in existence.**

Where an agreed framework exists, the standard-setting body acts as an architect or designer, building accounting rules on the foundation of sound, agreed basic principles.

7.3 ADVANTAGES AND DISADVANTAGES OF A CONCEPTUAL FRAMEWORK

Advantages

- The situation is avoided whereby standards are **developed on a piecemeal basis** as a reaction to a particular accounting problem which has emerged. In this situation, resources may be channelled into standardising accounting practice in that area, without regard to whether that particular issue is necessarily the most important issue at that time. Standards developed in this way may be **inconsistent** with basic concepts and with each other.
- The situation is also avoided where there are significant 'gaps' and certain topics are never addressed. For example, before the development of the IASB's and the US FASB's conceptual frameworks there were no formal definitions of terms such as 'asset', 'liability' or 'equity'.

- The development of certain standards (particularly national standards) has been subject to considerable **political interference** from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be less open to criticism that the standard-setter acceded to external pressure.
- The existence of a framework of principles means that it is much harder for preparers to avoid complying with reporting requirements. Rules can be avoided, but **preparers must apply the 'spirit'** and reasoning behind standards based on principles.
- Standard setters may become **more accountable** to the users of financial statements, because the reasoning behind specific standards should be clear. It should also be clear to users when standard setters have departed from the principles set out in the framework.
- The process of developing standards should be **easier and less costly** because the basic principles that underpin them have already been debated and established.
- Business is becoming increasingly complex. Accounting standards cannot cover all eventualities and in practice the development of standards has lagged behind the growth in particular types of complex transaction (for example, in 'off balance sheet' finance). A conceptual framework provides **principles that can be applied where there is no relevant accounting standard** or other guidance.
- The existence of a conceptual framework contributes to the **general credibility** of financial reporting and **increases public confidence** in financial statements.

Disadvantages

- Financial statements are intended for a **variety of users**, and it is not certain that a single conceptual framework can be devised which will suit all users.
- Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a **different purpose** (and with different concepts as a basis).
- It is not clear that a conceptual framework makes the task of **preparing and then implementing** standards any easier than without a framework.
- In practice, conceptual frameworks can lead to accounting standards which are very **theoretical and academic**. They may increase the complexity of financial information and lead to solutions that are conceptually pure but are difficult to understand and apply for many preparers and users.
- Conceptual frameworks tend to focus on the **usefulness** of financial information in making 'hold or sell' **decisions about an investment**. However, many users of financial statements are also interested in information that will help them assess the **stewardship** of management.
- In addition, accounting principles **focus only on economic phenomena**: transactions that can be expressed in money terms. Many believe that other aspects of an entity's operations, such as its effect on the natural environment or on the wider community, should be at least equally important in assessing its performance and making investment decisions.

Before we look at the IASB's attempt to produce a conceptual framework, we need to consider another element of importance to this debate: Generally Accepted Accounting Principles or GAAP.

7.4 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

We defined **GAAP** earlier in this module as all of the rules, from whatever source, which govern accounting.

There are different views of GAAP in different countries. The UK position can be explained in the following extracts from *UK GAAP* (Davies, Paterson & Wilson, Ernst & Young, 5th edition).

Our view is that GAAP is a dynamic concept which requires constant review, adaptation and reaction to changing circumstances. We believe that use of the term "principle" gives GAAP an unjustified and inappropriate degree of permanence. GAAP changes in response to changing business and economic needs and developments. As circumstances alter, accounting practices are modified or developed accordingly… We believe that GAAP goes far beyond mere rules and principles, and encompasses contemporary permissible accounting **practice**.

It is often argued that the term "generally accepted" implies that there must exist a high degree of practical application of a particular accounting practice. However, this interpretation raises certain practical difficulties. For example, what about new areas of accounting which have not, as yet, been generally applied? What about different accounting treatments for similar items – are they all generally accepted?

It is our view that "generally accepted" does **not** mean "generally adopted or used". We believe that, in the UK context, GAAP refers to accounting practices which are regarded as permissible by the accounting profession. The extent to which a particular practice has been adopted is, in our opinion, not the overriding consideration. Any accounting practice which is legitimate in the circumstances under which it has been applied should be regarded as GAAP. The decision as to whether or not a particular practice is permissible or legitimate would depend on one or more of the following factors:

- Is the practice addressed either in the accounting standards, statute or other official pronouncements?
- If the practice is not addressed in UK accounting standards, is it dealt with in International Accounting Standards, or the standards of other countries such as the US?
- Is the practice consistent with the needs of users and the objectives of financial reporting?
- Does the practice have authoritative support in the accounting literature?
- Is the practice being applied by other companies in similar situations?
- Is the practice consistent with the fundamental concept of "true and fair"?

This view is not held in all countries. In the US particularly, the equivalent of a 'true and fair view' is 'fair presentation in accordance with GAAP'. Generally Accepted Accounting Principles are defined as those principles which have 'substantial authoritative support'. Therefore, accounts prepared in accordance with accounting principles for which there is not substantial authoritative support are presumed to be misleading or inaccurate.

The effect here is that 'new' or 'different' accounting principles are not acceptable unless they have been adopted by the mainstream accounting profession, usually the standard-setting bodies and/or professional accountancy bodies. This is much more rigid than the UK view expressed above.

In contrast, however, in Australia there does not seem to be any strong body of opinion on GAAP. GAAP is only used by Australian companies if they need to prepare financial statements to US standards in order to raise funds from, or obtain a listing, in the US. Otherwise, Australian companies implement IFRS and the pronouncements of the IASB and AASB.

8 THE IASB'S *CONCEPTUAL FRAMEWORK*

Section overview

- The *Conceptual Framework* provides the theoretical framework for the development of IFRS.

The IASB's *Conceptual Framework for Financial Reporting* is, in effect, the **theoretical** framework upon which all IFRS are based and therefore determines how financial statements are prepared and the information they contain.

The *Conceptual Framework* consists of several sections or chapters, following on after a preface and introduction. Some of these chapters have been adopted from the previous *'Framework for the Preparation and Presentation of Financial Statements'* and will be replaced in due course.
The chapters are as follows:

- the objective of general purpose financial reporting (see below);
- the reporting entity (not yet issued);
- qualitative characteristics of useful financial information (see later in this module); and
- the Framework 1989
  - underlying assumption – going concern (see below)
  - the elements of financial statements (see below)
  - recognition of the elements of financial statements (see below)
  - measurement of the elements of financial statements (see Module 2)
  - concepts of capital and capital maintenance (see Module 2)

8.1 INTRODUCTION

The introduction to the *Conceptual Framework* points out the fundamental reason why financial statements are produced worldwide, that is, to **satisfy the requirements of external users**, but that practice varies due to the individual pressures in each country. These pressures may be social, political, economic or legal, but they result in variations in practice from country to country, including the form of statements, the definition of their component parts (assets, liabilities, equity, income, expenses), the criteria for recognition of items and both the scope and disclosure of financial statements.

The IASB wishes to narrow these differences by **harmonising** all aspects of financial statements, including the regulations governing their accounting standards and their preparation and presentation.

The introduction emphasises the way financial statements are used to make economic decisions.

Question 5: Economic decisions

Financial statements provide information that helps users to make economic decisions. What are the main types of economic decision for which financial statements are likely to be used?

(The answer is at the end of the module.)

8.2 PURPOSE AND STATUS

The introduction gives a list of the purposes of the *Conceptual Framework*.

- assist the members of the IASB in the **development of future IFRS** and in its review of existing IFRS
- assist the members of the IASB in **promoting harmonisation** of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRS
- assist **national standard-setting bodies** in developing national standards
- assist **preparers of financial statements** in applying IFRS and in dealing with topics that have yet to form the subject of an IFRS
- assist **auditors** in forming an opinion as to whether financial statements comply with IFRS;
- assist **users of financial statements** in interpreting the information contained in financial statements prepared in compliance with IFRS
- provide those who are interested in the work of IASB with **information** about its approach to the formulation of IFRS

The *Conceptual Framework* itself is not an International Financial Reporting Standard and so does not overrule any individual IFRS. In the rare cases of conflict between an IFRS and the *Conceptual Framework*, the **IFRS will prevail**. These cases will diminish over time to the extent that the *Conceptual Framework* is used as a guide in the production of future IFRS. The *Conceptual Framework* itself will be revised occasionally depending on the experience of the IASB in using it.

8.3 SCOPE

The *Conceptual Framework* deals with:

- the **objective** of financial reporting;
- the **qualitative characteristics** that determine the usefulness of information in financial statements;
- the **definition, recognition and measurement** of the elements from which financial statements are constructed; and
- concepts of **capital and capital maintenance**.

The *Conceptual Framework* is concerned with general purpose financial reporting. The term is not defined or discussed in the *Conceptual Framework*, but generally means a normal set of annual financial statements or published annual report available to users outside the reporting entity (see section 2.2).

9 THE OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

Section overview

- The *Conceptual Framework* states that:

  'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.'

These decisions involve buying, selling or holding share capital and debt instruments (such as loan stock or debentures) and providing or settling loans and other forms of credit.

The *Conceptual Framework* explains that investors and lenders **must normally rely on general purpose financial reports** for most of the financial information that they need. Therefore they are the **primary users** to which general purpose financial reports are directed.

The **focus is on capital providers** as the primary users of financial statements. Traditionally, in many countries there has been a second objective of financial statements: to show the results of the **stewardship** of management (the accountability of management for the resources entrusted to it). The revised *Conceptual Framework* does not explicitly state this or use the term 'stewardship'. It does, however explain that investors and other capital providers need information about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. These responsibilities may include the protection of the entity's resources from unfavourable effects of economic factors (such as price changes) and compliance with applicable laws and regulations.

General purpose financial reports cannot provide all the information that investors, lenders and other creditors need. They **may also need to consider** relevant **information from other sources**, for example, general economic conditions and expectations, political events and information about the industry in which the company operates.

The *Conceptual Framework* explains that other users, such as regulators and members of the public may also find general purpose financial reports useful. However, financial reports are not primarily prepared for these groups of users.

Question 6: Users of financial information

Earlier in this module, we discussed the users of accounting information. List the seven groups of users and describe the information needs of each group.

(The answer is at the end of the module.)

9.1 ECONOMIC RESOURCES, CLAIMS AND CHANGES IN RESOURCES AND CLAIMS

Financial reports provide information about the **financial position** of an entity:

- its **economic resources**; and
- the **claims** against it.

They also provide information about **changes** in an entity's economic resources and claims.

In other words, financial reports provide information about an entity's assets (which will generate economic benefits in future) and liabilities (which will deplete economic benefits in future) in order to determine the net position (assets minus liabilities) and how that net position changes. Information about the entity's economic resources and the claims against it helps users to assess the entity's **liquidity** and **solvency,** its **needs for additional finance** and how successful it is likely to be in obtaining it.

Definitions

Liquidity. The availability of sufficient funds to meet **short-term** financial commitments as they fall due.

Solvency. The availability of cash over the **longer term** to meet financial commitments as they fall due.

Changes in an entity's economic resources and claims result from its **financial performance** and also from other transactions and events such as the issue of shares or an increase in debt (borrowings).

Information about a reporting entity's **financial performance** helps users to understand the **return** that the entity has produced on its economic resources. This is an indicator of **how efficiently and effectively management has used the resources of the entity** and is helpful in predicting future returns.

Information about an entity's financial performance helps users to assess the entity's past and future **ability to generate net cash inflows from its operations**.

Information about a reporting entity's **cash flows** during a period also helps users assess the entity's ability to generate future net cash inflows and provides information about factors that may affect its liquidity or solvency. It also gives users a better understanding of the entity's operations and of its financing and investing activities.

10 ACCOUNTING REGULATION

LOs 1.6, 1.7

Section overview

- Accounting regulation is necessary to reduce subjectivity in producing financial reports and to increase comparability.

10.1 ACCOUNTING STANDARDS

In an attempt to deal with some of the subjectivity that may occur in producing financial reports and to achieve comparability between different organisations, **accounting standards** were developed. These standards are developed at both a national level (in most countries) and an international level. In this Study Guide we are concerned with **International Accounting Standards** (IAS) and **International Financial Reporting Standards** (IFRS).

The role of accounting standards is discussed in more detail later in this module.

10.2 ACCOUNTING FOR SITUATIONS WHERE ACCOUNTING STANDARDS DO NOT EXIST

When there is no specific legal regulation or accounting standard which covers an item in the accounts, the accountant must make a decision on how this item will be dealt with in the financial statements. It may be possible to account for the item following the accounting treatment of a similar item. The accountant may need to make a judgment on the treatment of the item and account for it so that the financial statements show a true and fair view or a fair presentation of the financial performance and financial position of the entity.

10.3 USE OF CONCEPTUAL FRAMEWORK

A conceptual framework, such as the IASB *Conceptual Framework* can be beneficial in situations where transactions are not covered by an accounting standard. The IASB's *Conceptual Framework* includes definitions of the elements of financial statements, that is, assets, liabilities, equity, income and expenses, and their recognition criteria. The *Conceptual Framework* also includes the qualitative characteristics of financial information – these are the characteristics that financial information should contain if it is to be useful to users. Therefore, the accountant will have sufficient information contained within the *Conceptual Framework* to be able to exercise judgment and decide how to deal with the transaction in a way that properly represents the underlying transaction.

For example, the accountant can refer to the definitions of assets and liabilities and consider whether the transaction gives rise to new assets or new liabilities.

In this situation, the *Conceptual Framework* serves as a useful basis for accountants to refer to when dealing with transactions not covered by an accounting standard. As the same recognition principles are included in accounting standards, the outcome should be a consistent method of accounting regardless of the detail in standards.

11 FUTURE DEVELOPMENTS

Section overview

- The IASB is currently developing a new *Conceptual Framework*.

11.1 REVISED FRAMEWORK

The IASB is carrying out a project to develop a new *Conceptual Framework*. This project originally began as part of the process of convergence of IFRS and US GAAP (see earlier in this module).

The IASB has stated that the aim of the project to revise the *Framework* is to 'create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged.'

11.2 PROGRESS TO DATE

The current IASB *Conceptual Framework for Financial Reporting* consists of the original IASB *Framework for the Preparation and Presentation of Financial Statements* (originally issued in 1989) with some chapters replaced by those parts of the new *Conceptual Framework* that have been finalised.

To date the IASB has finalised chapters on the objectives and qualitative characteristics of financial statements and has issued an Exposure Draft of a chapter on The Reporting Entity. These chapters were developed jointly with the US FASB.

The FASB is no longer involved in the project and the IASB is developing the remainder of the new *Conceptual Framework* alone.

In July 2013 the IASB issued a Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting*. This covers the issues that the IASB/FASB joint project had not yet addressed: definitions of the elements of financial statements; recognition and derecognition; measurement; and presentation and disclosure. The IASB does not intend to reconsider the objective of financial statements or the qualitative characteristics of useful financial information.

Two exposure drafts (ED/2015/3 *Conceptual Framework for Financial Reporting* and ED/2015/4 *Updating References to the Conceptual Framework* were published in 2015. Currently the IASB expect to publish a revised *Conceptual Framework* in late 2017. The revised framework will have some significant differences, for example, they have updated the definition of assets and liabilities. The new definitions will focus more on the fact that an asset is a resource and a liability is an obligation. The IASB have also removed the notion of probability from the definitions.

12 ACCOUNTING POLICIES

Section overview

- Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.
- An entity should select accounting policies that provide users of the financial statements with information that is relevant and reliable in order to ensure that the financial statements are prepared in accordance with GAAP.

Accounting policies are defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

Definition

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

You will see from this definition that companies have some choice in the matter of accounting policies. How to apply a particular accounting standard, where a choice exists, is a matter of accounting policy. How items are presented in the financial statements (including the notes), where alternative presentations are allowed, is a matter of accounting policy. Policies should be chosen to comply with IFRS, but with the overriding need for fair presentation.

The first note to a company's financial statements is the disclosure of accounting policies. This may include the depreciation policy and other issues, such as valuation of inventory or revaluation of non-current assets.

Another term used is **estimation techniques**, sometimes called **accounting estimates**. These involve the use of judgment when applying accounting policies. For instance, the accounting policy may state that non-current assets are depreciated over their expected useful life. The decision regarding the

length of useful life is a matter of **estimation**. The decision regarding method of depreciation is also a matter of estimation, rather than accounting policy.

There is the further matter of **measurement bases**. Is the value of the asset, upon which its depreciation is based, stated at original cost or revalued amount or current replacement cost? This is the measurement basis and will be stated in the accounting policy. The company must disclose in the notes to the accounts any change of accounting policy. Any change in **measurement basis** is regarded as a change of accounting policy and must be disclosed. Any change in **estimation technique** is not a change of accounting policy; however the effects of such a change on the current and future periods should be disclosed.

12.1 OBJECTIVES IN SELECTING ACCOUNTING POLICIES

In selecting accounting policies, businesses should seek to satisfy two primary criteria: relevance and reliability. These criteria are characteristics of useful financial information.

The IASB's *Conceptual Framework for Financial Reporting* uses the terms **relevance** and **faithful representation**. We will look at the characteristics of useful financial information in more detail in the next module.

12.1.1 RELEVANCE

Appropriate accounting policies will result in the presentation of **relevant** financial information. Financial information is relevant if it is:

- capable of influencing the economic decisions of users; and
- provided in time to influence those decisions.

Relevant information possesses either predictive or confirmatory value or both.

12.1.2 FAITHFUL REPRESENTATION

Financial information meets the faithful representation criterion if:

- it reflects the **substance of transactions** that is, represents faithfully what has taken place;
- it is free from bias, or is **neutral**;
- it is free from **material error**;
- it is **complete**; and
- **prudence** (caution) has been applied where there is any uncertainty.

Question 7: Accounting policy

Decide whether or not these represent a change of accounting policy:

(a) The company has previously included certain overheads within cost of sales. It now proposes to show those overheads within administrative expenses.

(b) A company has previously depreciated vehicles using the reducing balance method at 40 per cent per year. It now proposes to depreciate vehicles using the straight-line method over five years.

(c) A company has previously measured inventory at weighted average cost. It now proposes to measure it on a First In, First Out (FIFO) basis.

(The answer is at the end of the module.)

13 IAS 8 *ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS*

Section overview

- IAS 8 deals with the treatment of changes in accounting estimates, changes in accounting policies and errors.

13.1 DEFINITIONS

The following definitions are given in IAS 8:

Definitions

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Material: Omissions or misstatements of items are **material** if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. (This is very similar to the definition in the *Conceptual Framework*.)

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

Prospective application of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

- applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
- recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

Impracticable: Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following apply:

- The effects of the retrospective application or retrospective restatement cannot be determined.
- The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.

- The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
  - provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and
  - would have been available when the financial statements for that prior period were authorised for issue, from other information.

(IAS 8)

13.2 DETERMINING ACCOUNTING POLICIES

Accounting policies are determined by **applying the relevant IFRS** and considering any relevant Implementation Guidance issued by the IASB for that IFRS.

Where there is no applicable IFRS management should use its **judgment** in developing and applying an accounting policy that results in information that is **relevant** and **reliable**.

Management should refer to:

- the requirements of IFRS dealing with **similar** and **related issues**; and
- the definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the *Conceptual Framework*.

Management may also consider the most recent pronouncements of **other standard-setting bodies** that use a similar conceptual framework to develop Standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

An entity must select and apply its accounting policies for a period **consistently** for similar transactions, other events and conditions, unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS requires or permits categorisation of items, an appropriate accounting policy must be selected and applied consistently to each category.

13.3 CHANGES IN ACCOUNTING POLICIES

Changes in accounting policy are normally applied retrospectively.

The same accounting policies are usually adopted from period to period, to allow users to analyse trends over time in profit, cash flows and financial position. **Changes in accounting policy will therefore be unusual** and should be made only if:

- the change is required by an **IFRS**; or
- the change will result in a **more relevant and reliable presentation** of events or transactions in the financial statements of the entity.

13.3.1 ADOPTION OF AN IFRS

Where a new IFRS is adopted, IAS 8 requires any transitional provisions in the new IFRS itself to be followed. If none are given in the IFRS which is being adopted, then the general principles of IAS 8 should be followed.

13.3.2 OTHER CHANGES IN ACCOUNTING POLICY

IAS 8 requires **retrospective application**, unless it is **impracticable** to determine the cumulative amount of change. Any resulting adjustment should be reported as an adjustment to the opening balance of retained earnings. Comparative information should be restated unless it is impracticable to do so.

This means that all comparative information must be restated **as if the new policy had always been in force**, with amounts relating to earlier periods reflected in an adjustment to opening reserves of the earliest period presented.

There is **one important exception**. Where an entity **revalues assets** for the first time this is treated as a revaluation under IAS 16 *Property, Plant and Equipment*, not as a change of accounting policy under IAS 8. Therefore it is not applied retrospectively.

If, at the beginning of the current period, it is impracticable to determine the cumulative effect of applying a new accounting policy to **prior** periods, the entity should adjust the comparative information to apply the new accounting policy **prospectively** only.

13.3.3 DISCLOSURES

Certain **disclosures** are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods:

- reasons for the change
- amount of the adjustment for the current period and for each period presented
- amount of the adjustment relating to periods prior to those included in the comparative information
- the fact that comparative information has been restated or that it is impracticable to do so

An entity should also disclose information relevant to assessing the **impact of new IFRS** on the financial statements where these have **not yet come into force**.

Question 8: Change in accounting policy

During the year ended 31 December 20X7 MM Manufacturing decided to change its accounting policy for inventory valuation from FIFO to weighted average.

Extracts from the financial statements for 20X6 (final) and 20X7 (draft) prior to this change were as follows:

	20X6 $'000	20X7 (draft) $'000
Sales	50 000	54 000
Cost of goods sold	(24 000)	(26 000)
Profit before taxes	26 000	28 000
Income taxes (× 30%)	(7 800)	(8 400)
Profit for the period	18 200	19 600

The estimated values of MM's inventory under the FIFO and weighted average methods were as follows:

	31.12.X5 $'000	31.12.X6 $'000	31.12.X7 $'000
FIFO	2 800	2 900	2 950
Weighted average	2 700	2 750	2 870

Required

Show the impact of this change of policy on the statement of profit or loss for 20X7, with the 20X6 comparative.

(The answer is at the end of the module.)

13.4 CHANGES IN ACCOUNTING ESTIMATES

Changes in accounting estimate are **not** applied retrospectively.

Estimates arise in relation to business activities because of the **uncertainties inherent within them**. Judgments are made based on the most up to date information and the use of such estimates is a necessary part of the preparation of financial statements. It does not undermine their reliability. Here are some examples of accounting estimates:

- a necessary **irrecoverable debt allowance**
- **useful lives** of depreciable assets
- provision for **obsolescence of inventory**

The rule here is that the **effect of a change in an accounting estimate** should be accounted for prospectively that is, it should be included in profit before tax or loss in either:

- the period of the change, if the change affects that period only; or
- the period of the change and future periods, if the change affects both.

An example of a change in accounting estimate which affects only the **current period** is the irrecoverable debt estimate. However, a revision in the life over which an asset is depreciated would affect both the **current and future periods**, in the amount of the depreciation expense.

The effect of a change in an accounting estimate should be included in the **same expense classification** as was used previously for the estimate. This rule helps to ensure **consistency** between the financial statements of different periods.

The **materiality** of the change is also relevant. The nature and amount of a change in an accounting estimate that has a material effect in the current period (or which is expected to have a material effect in subsequent periods) should be disclosed. If it is not possible to quantify the amount, this impracticability should be disclosed.

Question 9: Change in accounting estimate

On 1 January 20X3, an asset was purchased by MM Manufacturing for $100 000. It had an estimated useful economic life of 10 years, and was depreciated on the straight line basis. On 31 December 20X7 a review of non-current assets indicated that the asset would continue to be useable until 31 December 20X9.

Required

Explain the accounting treatment for this asset.

(The answer is at the end of the module.)

13.5 ERRORS

Material prior period errors must be corrected **retrospectively**.

Errors discovered during a current period which **relate to a prior period** may arise through:

- mathematical mistakes;
- mistakes in the application of accounting policies;
- misinterpretation of facts;
- oversights; and/or
- fraud.

Most of the time these errors can be **corrected through profit before tax or loss for the current period**. Where they are **material prior period errors**, however, this is not appropriate.

13.5.1 ACCOUNTING TREATMENT

Material prior period errors must be corrected retrospectively.

This involves:

(a) either restating the comparative amounts for the prior period(s) in which the error occurred; or

(b) when the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period

so that the financial statements are presented **as if the error had never occurred**.

Only where it is **impracticable** to determine the cumulative effect of an error on prior periods can an entity correct an error **prospectively only**.

Various **disclosures** are required:

(a) the **nature** of the prior period error;

(b) for each prior period, to the extent practicable, the **amount** of the correction:

  (i) for each financial statement line item affected.

  (ii) for basic and diluted earnings per share (if disclosed);

(c) the amount of the correction at the **beginning of the earliest prior period** presented; and

(d) if **retrospective restatement is impracticable** for a particular prior period, the **circumstances** that led to the existence of that condition and a description of how and from when the error has been corrected. Subsequent periods need not repeat these disclosures.

Question 10: Error

During 20X7 Global discovered that certain items had been included in inventory at 31 December 20X6, valued at $4.2m, which had in fact been sold before the year end. The following figures for 20X6 (as reported) and 20X7 (draft) are available.

	20X6 $'000	20X7 (draft) $'000
Sales	47 400	67 200
Cost of goods sold	(34 570)	(55 800)
Profit before taxation	12 830	11 400
Income taxes	(3 849)	(3 420)
Profit for the period	8 981	7 980

Retained earnings at 1 January 20X6 were $13m. The cost of goods sold for 20X7 includes the $4.2m error in opening inventory. The income tax rate was 30 per cent for 20X6 and 20X7. No dividends have been declared or paid.

Required

Show the statement of profit or loss and other comprehensive income for 20X7, with the 20X6 comparative, and retained earnings.

(The answer is at the end of the module.)

KEY MODULE POINTS 2

- A conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.
- There are advantages and disadvantages to having a conceptual framework.
- The IASBs *Conceptual Framework for Financial Reporting* provides the theoretical framework for the development of IFRS. The *Conceptual Framework* is being progressively updated by the IASB.
- The *Conceptual Framework* states that:

  'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.'
- The IASB has been developing a new *Conceptual Framework* and it is expected to be published late in 2017.
- Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.
- An entity should select accounting policies that provide users of the financial statements with information that is relevant and reliable.
- IAS 8 deals with the treatment of changes in accounting estimates, changes in accounting policies and errors.
- A change in accounting policy is only allowed where it is required by legislation, by a new accounting standard or when it will result in more appropriate presentation.
- A change in accounting policy is applied retrospectively.
- A change in accounting estimate is applied prospectively.
- A prior period error is corrected retrospectively.

QUICK REVISION QUESTIONS 2

1 A conceptual framework is
   A the proforma financial statements.
   B a list of key terms used by the IASB.
   C a theoretical expression of accounting standards.
   D a statement of theoretical principles which form the frame of reference for financial reporting.

2 Which of the following is an advantage of a conceptual framework?
   A A framework encourages standardised accounting practice.
   B The framework does not simplify the preparation and implementation of standards.
   C There are a variety of users, so not all will be satisfied with the content of the framework.
   D There are a variety of accounting situations which mean flexibility in the accounting approach is needed.

3 What is the name of the IASB's conceptual framework?
   A *Statement of Principles for Financial Reporting*
   B *The Conceptual Framework for Financial Reporting*
   C *The Conceptual Framework for the Disclosure of Financial Statements*
   D *The Conceptual Framework for the Presentation of Financial Statements to Users*

4 What is the fundamental reason that financial statements are produced, according to the preface of the IASB's *Conceptual Framework*?
   A to provide information to tax authorities
   B to satisfy the requirements of external users
   C to provide information for internal management
   D to report on a company's performance to its national government

5 Which of the following are uses of financial statements prepared by a company?
   I. inclusion in national income statistics
   II. decisions to buy, hold or sell equity investments
   III. assessment of the security of amounts lent to the entity
   IV. assessment of management stewardship and accountability

   A I and II only
   B II and IV only
   C III and IV only
   D I, II, III and IV

6 According to the *Conceptual Framework*, who are the most important users of general purpose financial reports?
   A investors and lenders
   B investors and employees
   C lenders and management
   D investors and the government

7 If an accountant comes across a transaction that is not covered by an accounting standard, where should they look for guidance on accounting for that item?
   A UK GAAP
   B US GAAP
   C company law
   D conceptual framework

8 Which of the following constitute a change of accounting policy according to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*?

I. a change in depreciation method
II. a change in the basis of valuing inventory
III. adopting an accounting policy for a new type of transaction not previously dealt with
IV. a decision to capitalise borrowing costs relating to the construction of non-current assets, rather than writing them off as incurred

A I and II only
B I and III only
C I and IV only
D II and IV only

9 Which of the following items would qualify for treatment as a change in accounting estimate, according to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*?

I. provision for obsolescence of inventory
II. correction necessitated by a material error
III. a change in the useful life of a non-current asset
IV. a change as a result of the adoption of a new International Accounting Standard

A I and III only
B I and IV only
C II and III only
D I, II, III and IV

14 THE ROLE OF ACCOUNTING STANDARDS

LO 1.7

Section overview

- There are two different approaches to developing accounting standards: principles-based, and rules based. Principles-based standards are developed according to a set of laid down principles. Rules-based standards regulate for issues as they arise. Both these approaches have advantages and disadvantages.
- Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements.

14.1 SUBJECT OUTLINE

The next few sections of this module will examine the purpose of accounting standards as the means of setting out the accounting rules to be followed. First, we will discuss the two different methods of setting accounting rules, the principles-based and rules-based approaches and then look at the role of accounting standards in more detail.

14.2 PRINCIPLES-BASED VERSUS RULES-BASED SYSTEMS

A principles-based system works within a set of defined principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.

The IASB's *Conceptual Framework for Financial Reporting* is intended to provide the underlying principles within which standards can be developed. One of the main purposes of a conceptual framework is to ensure that standards are not produced which are in conflict with each other. In addition, any departure from a standard can be judged on the basis of whether or not it is in keeping with the principles set out in the *Conceptual Framework*. A **principles-based** system of accounting is a **system which is based on a conceptual framework**.

The opposite of a principles based system is a **rules-based system**, in which there are a number of detailed regulations designed to cover every eventuality.

In practice, most standard setting bodies, including the IASB, have developed or adopted standards that are a mixture of principles and rules. IFRS can currently be viewed as a 'hybrid' system: there is a conceptual framework and many standards are principles-based, but some standards (mainly those influenced by US GAAP) are rules-based.

14.3 THE DIFFERENCES BETWEEN A PRINCIPLES-BASED SYSTEM AND A RULES-BASED SYSTEM

A rules-based system requires preparers to understand and **apply detailed rules** to report specific transactions.

A principles-based system requires preparers to **use judgment** in order to develop accounting policies to report specific types of transactions and events.

Consider accounting for tangible non-current assets. An extreme rules-based approach would set out precise requirements for each type of asset, for example:

> 'Plant and equipment should be depreciated on the straight line basis over a period not exceeding four years.'

A principles-based approach would contain more general requirements, for example:

> 'The depreciable amount of an asset shall be allocated on a systematic basis over its useful life…The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.' (IAS 16 *Property, Plant and Equipment*)

Rules-based accounting standards often need to contain complex **definitions and scope exceptions**. For example, if plant and equipment must be depreciated over four years, while other classes of asset are depreciable over a longer period, the standard must define what is meant by plant and equipment. Standards often contain further material that explains and interprets the rules and this in turn may be supplemented by guidance and regulations relating to particular industries or types of transaction. As a result, accounting standards and guidance can be **voluminous**.

A purely rules-based system has the following advantages:

- in theory, it results in financial statements being **comparable** between entities (or between entities in the same industry);
- it may **reduce the volume of explanation necessary in financial statements** (as in theory there is only one allowed accounting treatment for each type of transaction or event);
- it is suitable for **large, complex economies** (such as the US); and
- it **provides the 'answers'** in almost all situations; preparers **do not have to make judgments** and risk the consequences (e.g. litigation or reputational damage if a user makes a wrong decision based on information in the financial statements).

Principles-based accounting standards are likely to be less lengthy and complex than rules-based standards, with fewer definitions and scope exceptions.

There may be an explicit requirement that the financial statements show a **'true and fair view'** of the entity's financial performance and financial position and that this requirement should override all others. An entity may depart from a requirement if management is convinced that this is necessary (normally in exceptional circumstances).

Standards normally require **very full disclosure** of information about the nature of transactions or events and the accounting policies adopted. This is seen as necessary in order for users to understand the information that is being presented in the financial statements and to make meaningful comparisons between different entities.

In practice, principles based standards often need to be accompanied or supported by **explanatory material, illustrative examples, and interpretations.** The IASB has a separate operating body that issues interpretations of standards where interpretation difficulties arise, while the Australian Accounting Standards Board appoints Interpretation Advisory Panels on an ad hoc basis.

A purely or mainly **principles-based system** has the following advantages:

- in theory, it is more likely than a rigid-rules based system to result in financial statements that show a **true and fair view/give a fair presentation**;
- it encourages the use of **professional judgment**;
- it is **less open to 'creative accounting' abuses** as principles are harder to evade than rules; and
- arguably it is **more flexible** than a system of rules and can therefore cope better with a rapidly changing business and economic environment.

See also the advantages of a conceptual framework we covered earlier in this module; many of these also apply here.

Question 11: What type of standard?

Below are extracts from IAS 38 *Intangible Assets*:

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

No intangible asset arising from research shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred.

An intangible asset arising from development activities shall be recognised if and only if an entity can demonstrate specific conditions.

Required

(a) What type of standard is this, rules-based or principles-based?

(b) Explain why the requirements above might **reduce** the usefulness of the information in the financial statements.

(The answer is at the end of the module.)

14.4 THE PURPOSE OF ACCOUNTING STANDARDS

Definition

Accounting standards. Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements.

Accounting standards form part of the Generally Accepted Accounting Principles (GAAP) that sets out the accounting rules that companies must abide by. They are structured to provide detailed guidance on accounting for a particular item. For example, there are a number of accounting standards that deal with the accounting treatment of items recognised in the financial statements such as non-current assets, provisions and liabilities.

Accounting standards are of key importance in the regulation process as they provide the detailed rules on dealing with transactions and disclosures in the financial statements. Without this detailed guidance, companies would be free to account for transactions as they wished, which would firstly reduce the comparability of financial statements and secondly, could lead to misleading accounts if companies report transactions in a more favourable light. Neither of these options would be beneficial to users of the financial statements.

In many countries, including Australia, accounting standards have the force of law. Some or all limited liability companies are required to comply with them in preparing financial statements. Listing authorities also require compliance with standards as a condition of obtaining a stock exchange listing. In some countries, including Australia and the UK, some not for profit entities and governmental organisations may also be required to comply with accounting standards.

Even where compliance is not an actual legal requirement (for example, for a small or unincorporated entity) the requirements of accounting standards are normally taken to represent 'best practice'.

14.4.1 ACCOUNTING STANDARDS AND THE CONCEPTUAL FRAMEWORK

We have already seen that a conceptual framework exists to provide a basis for the preparation of financial statements. In theory, accounting standards should be **consistent** with the principles of the conceptual framework. For example, any accounting standard dealing with the recognition of assets should include the definition of an asset from the conceptual framework as well as the relevant recognition criteria.

One of the stated purposes of the IASB's *Conceptual Framework* is to assist in applying IFRS. Where there is no accounting standard covering a particular transaction, the *Conceptual Framework* can be used to assist in developing an appropriate accounting treatment.

14.4.2 ACCOUNTING STANDARDS AND A FAIR PRESENTATION

The objective of financial statements is to provide information about the financial position and performance of an entity. Financial information should show a **fair presentation** or true and fair view of the activities of an entity.

Like 'true and fair view', 'present fairly' is not defined in the *Conceptual Framework* or in any IFRS. However, IAS 1 *Presentation of Financial Statements* explains that:

- Fair presentation requires the **faithful representation** of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework.*
- **Compliance with IFRS,** with additional disclosure where necessary, is **presumed to result in** financial statements that achieve a **fair presentation**.

We will examine the meaning of **faithful representation** later in this module.

The following points made by IAS 1 expand on this principle:

- If an entity has **complied with IFRS**, it should disclose that fact in its financial statements.
- **All relevant IFRS** must be followed if compliance with IFRS is disclosed.
- Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material.

Fair presentation involves more than mere compliance. Preparers should apply the 'spirit' (or **general intention**) behind an accounting standard as well as the strict 'letter'. The requirement to 'present fairly' also applies to transactions which are **not covered by any specific accounting standard.**

Fair presentation requires an entity to:

- select and apply **appropriate accounting policies**;
- **present information** in a manner that results in relevant, reliable, comparable and understandable information; and
- **provide additional disclosures** where these are necessary to enable users to understand the impact of particular transactions, other events and conditions on an entity's financial performance and position.

IAS 1 states that **disclosure** (explanatory material or notes) **does not rectify inappropriate accounting policies**.

15 ACCOUNTING STANDARDS AND CHOICE

Section overview

- There are arguments for and against having accounting standards.

It is sometimes argued that having accounting standards actually **reduces** the quality of financial reporting, and that individual companies should be given more **choice** over how they report transactions. There are arguments on both sides.

Many of the advantages and disadvantages of accounting standards are similar to the advantages and disadvantages of accounting regulation in general which we covered earlier in this module.

15.1 ADVANTAGES OF ACCOUNTING STANDARDS

Standards have the following **advantages**:

- They **reduce or eliminate confusing variations** in the methods used to prepare accounts and so **increase the usefulness** of financial information. Users of financial statements need to be able to **compare** an entity's financial performance and position with those of other, similar entities. They also need to be able to compare the performance and position of an entity over time, in order to evaluate trends. (For example, have sales increased or decreased compared with those of the previous period?)

- They make it **more difficult** for preparers to adopt accounting treatments that **deliberately mislead users**. Without accounting standards management could adopt the accounting treatments that produced the highest reported profit and the strongest financial position possible, even if these did not give a fair presentation.
- They **provide guidance** to preparers of financial statements. The business environment is becoming increasingly complex and some preparers may find it difficult to determine the appropriate accounting treatment for many types of transaction or event (for example, those involving derivative financial instruments or arrangements whose economic substance is not the same as their legal form).
- Financial statements prepared in accordance with accounting standards are based on generally accepted accounting practice and arguably this makes them **more understandable** than they would otherwise be.
- They generally **improve the quality** of general purpose financial reporting. Standards require entities to **disclose more** accounting information than they would otherwise have done if standards did not exist. This information includes the **accounting policies** used in the preparation of the financial statements. As well as increasing the amount of information that is available, in theory, standards help to ensure that the financial statements actually do provide **relevant information that users need**.
- They provide a focal point for **debate and discussions** about accounting practice and in that way contribute to the development of best practice.
- They are a **means of reaching a consensus** about the way in which particular items should be treated. The development of IFRS involves a full **consultative process** in which users and preparers are able to be directly involved.
- They are a **less rigid alternative** to enforcing conformity by means of legislation.
- They **improve the credibility** of financial reporting generally. Users are more likely to trust financial information if it has been prepared in accordance with accounting standards and other regulation than if they would be if standards did not exist.

15.2 DISADVANTAGES OF ACCOUNTING STANDARDS

The **disadvantages** of accounting standards are as follows:

- Not all entities are the same size or operate in the same industry. **An accounting treatment that is appropriate for some entities may not be appropriate for others.** The use of an inappropriate accounting treatment may actually reduce the quality of the information provided.
- The development of accounting standards and other regulation is a **political process** and may be affected by **lobbying or government pressure**. Although anyone can comment on a proposed standard, most commentators tend to be large listed companies or large professional firms: organisations with considerable power to influence standard setters in their own interests.
- Most recent standards have been developed to meet the needs of providers of capital to large public companies. For many smaller entities, **the cost of complying** (both in time and money) outweigh the benefits to users.
- Accounting standards **do not always prevent preparers from manipulating the figures**. Some preparers view them as a **set of rules that they can evade** through 'creative accounting'. (This is less likely if standards are based on principles and concepts rather than detailed rules.)
- Earlier standards were not based on a **conceptual framework** of accounting. This means that they may be inconsistent with one another. The IASB is committed to rectifying this.
- There may be a **trend towards rigidity**, and away from flexibility in applying the rules. Some commentators believe that preparers should be free to use their professional judgment on technical matters.
- Accounting standards often require **extensive disclosure**. It can be argued that this makes financial statements **harder to understand** and less useful.

- Accounting standards may have **unforeseen economic consequences** for the entities who have to apply them and for others and **may affect the commercial decisions** taken by management. For example, a company might avoid particular actions (such as investment in certain types of asset) that might benefit it in the long term, if they were required to treat the transactions in a way that dramatically reduced reported profit.

Case study: Economic consequences

The UK standard FRS 17 *Accounting for Retirement Benefits* changed the financial reporting treatment of some types of pension scheme (defined benefit schemes). This had the effect of significantly increasing the non-current liabilities of the companies that operated those schemes. As a result, most companies which operated defined benefit schemes closed them to new entrants and replaced them with pension arrangements that were much less advantageous to their employees.

It has been argued that accounting standards should reflect economic reality (e.g. companies that operate defined benefit schemes have a liability for the cost of providing pensions in future periods) and standard setters should not concern themselves with the possible consequences of requiring a particular accounting treatment. Recently, however, following the global economic crisis, a few commentators and politicians have begun to question this.

16 ACCOUNTING CONCEPTS

Section overview

- **Going concern** is an underlying assumption in preparing financial statements. It is the main underlying assumption stated in the *Conceptual Framework*.
- Financial information (other than information about cash flows) should be prepared on an **accruals** basis.

16.1 GOING CONCERN

Definition

Going concern. The entity is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations. *(Conceptual Framework)*

This concept assumes that, when preparing a normal set of accounts, the business will **continue to operate** in approximately the same manner for the foreseeable future (at least the next 12 months). In particular, the entity will not go into liquidation or scale down its operations in a material way.

The main significance of a business being a going concern is that:

1. Assets **should not be measured at their 'break-up' value** that is the amount they would sell for if they were sold off piecemeal and the business was broken up (unless the assets satisfy the requirements of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*). If assets are classified as held for sale in accordance with IFRS 5, they should be measured at the lower of carrying amount and fair value less costs to sell.
2. Liabilities are classified as current or non-current depending on when they are due to be settled.

16.1.1 EXAMPLE: GOING CONCERN

Emma acquires a T-shirt printing machine at a cost of $60 000. The asset has an estimated life of six years with a scrap value of nil at the end of six years, and it is normal to write off the cost of the asset to the statement of profit or loss over this time. In this case a depreciation cost of $10 000 per year is charged.

Using the going concern assumption, it is presumed that the business will continue its operations and so the asset will produce economic benefits throughout its full six years in use. A depreciation charge of $10 000 is made each year, and the value of the asset in the statement of financial position is its cost less the accumulated depreciation charged to date. After one year, the **carrying amount** of the asset is $(60 000 – 10 000) = $50 000, after 2 years it is $40 000, after 3 years $30 000 and so on, until it is written down to a value of 0 after 6 years.

This asset has no other operational use outside the business and, in a forced sale, it would only sell for scrap. After one year of operation, its scrap value is $8000.

The carrying amount of the asset, applying the going concern assumption, is $50 000 after 1 year, but its immediate sell-off value only $8000. It can be argued that the asset is over-valued at $50 000, that it should be written down to its break-up value ($8000) and the balance of its cost should be treated as an expense. However, provided that the going concern assumption is valid, it is appropriate accounting practice to value the asset at its carrying amount.

Question 12: Going concern

A retailer commences business on 1 January and buys inventory of 20 washing machines, each costing $100. During the year they sell 17 machines at $150 each. How should the remaining machines be valued at 31 December in the following circumstances?

(a) They are forced to close down the business at the end of the year and the remaining machines will realise only $60 each in a forced sale.

(b) They intend to continue the business into the next year.

(The answer is at the end of the module.)

If the going concern assumption is not followed, that fact must be disclosed, together with:

- the basis on which the financial statements have been prepared; and
- the reasons why the entity is not considered to be a going concern.

16.2 ACCRUALS BASIS OF ACCOUNTING

Definition

In the **accruals basis of accounting**, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Conceptual Framework. *(IAS 1)*

Entities should prepare their financial statements on the basis that transactions are recorded in them, not as the cash is paid or received, but as the revenues or expenses are **earned or incurred** in the accounting period to which they relate.

According to the accruals assumption, profit is computed as the surplus/(deficit) of revenue and expenses. In computing profit, revenue earned must be **matched against** the expenditure incurred in earning it. This is also known as the **matching convention**.

16.2.1 EXAMPLE: ACCRUALS

Emma prints 20 T-shirts in her first month of trading (May) at a cost of $5 each (purchased on credit terms). She then sells all of them for $10 each. Emma has therefore made a profit of $100, the surplus of revenue ($200) earned over the cost ($100) of acquiring them.

If, however, Emma only sells 18 T-shirts, it is incorrect to charge her statement of profit or loss (income statement) with the cost of 20 T-shirts, as she still has 2 T-shirts in inventory. If she sells them in June, she is likely to make a profit on the sale. Therefore, the profit is $90, the surplus of sales revenue ($180) over the purchase cost of 18 T-shirts ($90).

Her statement of financial position will look like this.

	$
Assets	
Inventory (at cost, i.e. 2 × $5)	10
Accounts receivable (18 × $10)	180
	190
Capital and liabilities	
Proprietor's capital (profit for the period: 18 × $5)	90
Accounts payable (20 × $5)	100
	190

However, if Emma had decided to give up selling T-shirts, then the going concern assumption no longer applies and the value of the 2 T-shirts in the statement of financial position is break-up valuation, not cost. Similarly, if the 2 unsold T-shirts are unlikely to be sold at more than their cost of $5 each (say, because of damage or a fall in demand) then they should be recorded on the statement of financial position at their **net realisable value** (i.e. the likely eventual sales price less any expenses incurred to make them saleable, i.e. say, $4 each) rather than cost. This shows the application of the **prudence concept**, which we will discuss shortly.

In this example, the concepts of going concern and accruals are linked. Since the business is assumed to be a going concern, it is possible to carry forward the cost of the unsold T-shirts as a charge against profits of the next period.

16.3 SUBSTANCE OVER FORM

Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality**, not solely based on its legal form.

Definition

Substance over form. The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

For instance, one party may sell an asset to another party and the sales documentation may record that legal ownership has been transferred. However, if agreements exist whereby the party selling the asset continues to enjoy the future economic benefits arising from the asset, then in substance no sale has taken place.

An example of substance over form is found in **accounting for leases**. A lease is a contract that conveys the right to use an asset for a period of time. In a lease the lessee never obtains legal title to the asset so does not own that asset. However, they have all the risks and rewards of ownership, such as the right to use the asset for most, if not all, of its useful life and they must bear the costs of ownership such as insurance and maintenance. For this reason, the asset is **capitalised** in the lessee's accounts and treated as an owned asset, following the substance of the transaction. This accounting treatment will ensure that the financial statements show the true financial position of the entity, and does not hide assets and liabilities from the statement of financial position.

In accounting for the lease above, if the legal form was followed, the asset and the lease liability would not be recognised which would make the financial statements look better than they actually are. This has the effect of improving the gearing ratio, as the liability is not recorded, it also improves the return on capital employed, as the asset base is lower. Hence following substance over form is key in showing a fair presentation of the financial statements of an entity.

Case study: Repo 105

After the investment bank, Lehman Brothers, collapsed in 2008 it was discovered that the bank had used a transaction known as 'Repo 105' to raise short-term finance. Financial assets were swapped for cash but with an agreement to buy them back at a future date. The substance of this transaction is that the 'seller' continues to control the asset, so it remains in the statement of financial position. The obligation to redeem for cash is recorded as a liability.

However, Lehman Brothers transferred assets worth 105 per cent of the cash it received in return. Because of this, under the rules in US GAAP it was able to record the transaction as a sale on the grounds that technically it had lost control of the assets and no longer owned them. Therefore the cash received was recorded as an asset rather than a liability. The bank's liabilities were significantly understated and it was able to mislead investors and lenders about its true financial position.

17 QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION

LO 1.6

Section overview

- Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.
- The two fundamental qualitative characteristics are: relevance and faithful representation.
- The four enhancing qualitative characteristics are: comparability, verifiability, timeliness and understandability.

The IASB's *Conceptual Framework for Financial Reporting* sets out and explains the qualitative characteristics of useful financial information.

There are two **fundamental qualitative characteristics**: **relevance** and **faithful representation**. Information must be possess these characteristics in order to be useful.

There are four **enhancing qualitative characteristics**: **comparability, verifiability, timeliness** and **understandability**. These qualities enhance the usefulness of financial information.

17.1 RELEVANCE

Relevant financial information has **predictive value, confirmatory value,** or **both**.

Definition

Relevance. Relevant financial information is capable of making a difference in the decisions made by users. *(Conceptual Framework)*

Information on financial position and performance is often used to **predict** future position and performance and other things of interest to the user, for example, likely dividend, wage rises. Financial information is also used to **confirm** (or change) users' past conclusions about an entity's financial performance or financial position.

Information can have both predictive value and confirmatory value. For example, revenue for the current year can be used to predict revenue for next year. Actual revenue for the current year can also be compared with expected revenue that was predicted using last year's financial statements.

17.1.1 MATERIALITY

The relevance of information is affected by its **materiality**.

Definition

Materiality. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. *(Conceptual Framework)*

The *Conceptual Framework* explains that materiality is entity-specific. It depends on the nature or size (or both) of items taken in the context of an individual entity's financial report.

Information may be judged relevant simply because of its nature, even though the amounts involved may be small in relation to the financial statements as a whole (for example, remuneration of management). In other cases, both the nature and materiality of the information are important. Materiality is not a primary qualitative characteristic itself because it is merely a threshold or cut-off point.

17.2 FAITHFUL REPRESENTATION

To be useful, financial information must faithfully represent the economic events that it purports to represent. The user must be able to depend on it being a **faithful representation**.

Definitions

Faithful representation. A faithful representation is **complete**, **neutral** and **free from error**.

A complete depiction includes all the information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A neutral depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.

Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made. *(Conceptual Framework)*

17.3 COMPARABILITY

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

The consistency of treatment is therefore important across like items over time, within the entity and across all entities.

The **disclosure of accounting policies** is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

Comparability is **not the same as uniformity** that is, items need not be identical in order to be comparable. For information to be comparable, like things must look alike and different things must look different, Comparability is not enhanced by making unlike items look alike. Therefore entities should change accounting policies if they become inappropriate.

Corresponding information for **preceding periods** should be shown to enable comparison over time.

17.4 VERIFIABILITY

Verifiability helps assure users that information faithfully represents the economic events it purports to represent.

Verifiability means that different knowledgeable and independent observers could reach consensus (not necessarily complete agreement) that a particular depiction is a faithful representation.

17.5 TIMELINESS

Timeliness means having information available to users in time to be capable of influencing their decisions.

Generally, the older the information is, the less useful it is. However, older financial information may still be useful for identifying and assessing trends (for example, growth in profits over a number of years).

17.6 UNDERSTANDABILITY

Classifying, characterising and presenting information clearly and concisely makes it **understandable**.

Some information is inherently complex and difficult to understand. Excluding this information from the financial statements would make them more understandable, but they would also be incomplete and potentially misleading.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. Users may sometimes need to seek help from an adviser in order to understand information about complex economic events.

17.7 APPLYING THE QUALITATIVE CHARACTERISTICS

Information must be both relevant and faithfully represented if it is to be useful. In practice, an entity must often find a balance between the two, with the aim of presenting the most relevant information that can be faithfully represented.

A faithful representation, by itself, does not necessarily result in useful information. Suppose that an entity receives a government grant to purchase an asset. The asset has no cost to the entity and therefore is not recognised in the statement of financial position. This is a faithful representation of the transaction, but users of the financial statements are not aware that the entity has the asset. They have been deprived of useful and relevant information.

The same principle applies to the enhancing qualitative characteristics. Sometimes, one characteristic may have to be diminished in order to maximise another. For example, applying a new standard may reduce comparability in the short term, but may improve relevance or faithful representation in the longer term.

17.8 THE COST CONSTRAINT ON USEFUL FINANCIAL REPORTING

Cost is a pervasive constraint on the information that can be provided by financial reporting. The *Conceptual Framework* explains that it is important that the costs of reporting financial information are justified by the benefits.

The IASB takes this into account when developing standards. It considers costs and benefits in relation to financial reporting generally, not just in relation to individual entities. Different reporting requirements for different reporting entities may be appropriate in some circumstances. For example, the IASB has recently developed a special standard for small and medium sized entities.

18 INTERNATIONAL FINANCIAL REPORTING STANDARDS

Section overview

- There are currently 16 IFRS in issue, as well as several International Accounting Standards (IAS).
- IFRS are having a growing influence on national accounting requirements and practices.
- Where a company has to change from a national GAAP to IFRS, it has to deal with a number of practical issues.

18.1 STANDARDS CURRENTLY IN ISSUE

The current list of International Accounting Standards and International Financial Reporting Standards is as follows:

INTERNATIONAL ACCOUNTING STANDARDS		DATE OF ISSUE
IAS 1 (revised)	Presentation of Financial Statements	Jun 2011
IAS 2	Inventories	Dec 2003
IAS 7	Statement of Cash Flows	Dec 1992
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	Dec 2003
IAS 10	Events after the Reporting Period	Dec 2003
IAS 12	Income Taxes	Nov 2000
IAS 16	Property, Plant and Equipment	Dec 2003
IAS 17	Leases	Dec 2003
IAS 19 (revised)	Employee Benefits	Jun 2011
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	Jan 1995
IAS 21	The Effects of Changes in Foreign Exchange Rates	Dec 2003
IAS 23 (revised)	Borrowing Costs	Jan 2008
IAS 24 (revised)	Related Party Disclosures	Nov 2009
IAS 26	Accounting and Reporting by Retirement Benefit Plans	Jan 1995
IAS 27 (revised)	Consolidated and Separate Financial Statements	May 2011
IAS 28 (revised)	Investments in Associates and Joint Ventures	May 2011
IAS 29	Financial Reporting in Hyperinflationary Economies	Jan 1995
IAS 32	Financial Instruments: Presentation	Dec 2003
IAS 33	Earnings per Share	Dec 2003
IAS 34	Interim Financial Reporting	Feb 1998
IAS 36	Impairment of Assets	Mar 2004
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	Sep 1998
IAS 38	Intangible Assets	Mar 2004
IAS 40	Investment Property	Dec 2003
IAS 41	Agriculture	Feb 2001

INTERNATIONAL FINANCIAL REPORTING STANDARDS		DATE OF ISSUE	EFFECTIVE DATE
IFRS 1 (revised)	First time Adoption of International Financial Reporting Standards	Nov 2008	1 Jul 2009
IFRS 2	Share-based Payment	Feb 2004	1 Jan 2005
IFRS 3 (revised)	Business Combinations	Jan 2008	1 Jul 2009
IFRS 4	Insurance Contracts	Mar 2004	1 Jan 2005
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	Mar 2004	1 Jan 2005
IFRS 6	Exploration for and Evaluation of Mineral Resources	Dec 2004	1 Jan 2006
IFRS 7	Financial Instruments: Disclosures	Aug 2005	1 Jan 2007
IFRS 8	Operating Segments	Nov 2006	1 Jan 2009
IFRS 9	Financial Instruments	Nov 2013	1 Jan 2018
IFRS 10	Consolidated Financial Statements	May 2011	1 Jan 2013
IFRS 11	Joint Arrangements	May 2011	1 Jan 2013
IFRS 12	Disclosure of Interests in Other Entities	May 2011	1 Jan 2013
IFRS 13	Fair Value Measurement	May 2011	1 Jan 2013
IFRS 14	Regulatory Deferral Accounts	Jan 2014	1 Jan 2016
IFRS 15	Revenue from Contracts with Customers	May 2014	1 Jan 2018
IFRS 16	Leases	Jan 2016	1 Jan 2019
IFRS 17	Insurance Contracts	May 2017	1 Jan 2021
IFRS for SMEs	International Financial Reporting Standard for Small and Medium sized Entities	Jul 2009	

18.2 SCOPE AND APPLICATION OF IFRS

18.2.1 SCOPE

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRS are **not intended to be applied to immaterial items**. An item is immaterial if its omission or misstatement would not influence decisions that users of financial statements make. Each individual IFRS lays out its scope at the beginning of the standard.

18.2.2 APPLICATION

Within each individual country **local regulations** govern, to varying degrees, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country concerned.

18.3 ALTERNATIVE TREATMENTS

Many of the old standards permitted two accounting treatments for like transactions or events. One treatment was designated as the **benchmark treatment** (effectively the **preferred treatment**) and the other was known as the **alternative treatment**. This is no longer the case. However, some standards do still allow more than one policy – for instance, IAS 16 allows property, plant and equipment to be carried at cost or revalued amount.

18.4 INTERPRETATION OF IFRS

The IFRS Interpretations Committee (as discussed earlier in this module) has the responsibility for issuing additional guidance on the application of an accounting standard where unsatisfactory or conflicting interpretations exist. The documents issued are called IFRICs. As at October 2016, there are 21 IFRICs in issue (of which 13 are still in force), together with 32 SICs (of which 27 have been superseded) which were issued by the IFRS Interpretations Committee's predecessor, the Standing Interpretations Committee.

The IFRS Interpretations Committee may also suggest IASB agenda items if there are financial reporting issues that are not specifically covered by an IFRS.

18.5 FAIR PRESENTATION OVERRIDE

There may be (very rare) circumstances when management decides that compliance with a requirement of an IFRS would be misleading. **Departure from the IFRS** is therefore required to achieve a fair presentation. IAS 1 *Presentation of Financial Statements* states that the following should be disclosed in such an event:

- management confirmation that the financial statements fairly present the entity's financial position, performance and cash flows;
- a statement that all IFRS have been complied with except departure from one IFRS to achieve a fair presentation;
- details of the nature of the departure, why the IFRS treatment would be misleading, and the treatment adopted; or
- financial impact of the departure.

This is sometimes referred to as the **'true and fair override'** or the **'fair presentation' override**. Not all jurisdictions allow the use of the 'true and fair' override. For example, in Australia, preparers of financial statements are not permitted to depart from any of the requirements of accounting standards (see section 6.10). Instead, the financial statements must disclose additional information.

18.6 EXTREME CASE DISCLOSURES

In very rare circumstances, management may conclude that compliance with a requirement in a Standard or Interpretation may be so **misleading** that it would **conflict with the objective** of financial statements set out in the *Conceptual Framework*, but the relevant regulatory framework prohibits departure from the requirements. IAS 1 states that in such cases the entity needs to reduce the perceived misleading aspects of compliance by **disclosing**:

- the title of the Standard, the nature of the requirement and the reason why management has reached its conclusion; and
- for each period, the adjustment to each item in the financial statements that would be necessary to achieve fair presentation.

18.7 WORLDWIDE EFFECT OF IFRS AND THE IASB

The IASB, and before it the IASC, has now been in existence for around 40 years, and it is worthwhile considering the effect it has had in that time.

As far as **Europe** is concerned, the consolidated financial statements of many of Europe's top multinationals are now prepared in conformity with national requirements, European Commission (EC) directives and IFRS. Furthermore, IFRS are having a growing influence on national accounting requirements and practices. Many of these developments have been given added impetus by the internationalisation of capital markets.

Australia has wholly adopted IFRS and issues Australian Equivalent International Financial Reporting Standards (AIFRS). The AASB adopted IFRS for annual reporting periods for companies from 1 January 2005. This means that all general financial purpose statements prepared by for-profit entities prepared in accordance with AASB are also in accordance with IFRS.

In 2006, **China** officially released a new set of Chinese Accounting Standards (CASs) which are substantially converged with IFRSs, and reaffirmed its commitment to international convergence.

In 2005, the IASB and the Accounting Standards Board of **Japan** (ASBJ) announced a joint project to reduce differences between IFRSs and Japanese accounting standards. Since 2010, Japanese listed companies meeting certain criteria have been permitted to use IFRSs as designated by The Financial Services Agency of Japan. Consultation is also underway on the use of IFRSs in Japan.

Until recently, the US was one of the few countries in which IFRS financial statements were not accepted. However, over the last 10 years the US authorities have moved significantly closer to recognising IFRS, although it is unlikely that the US will adopt IFRSs in the near future. Convergence of IFRS and US GAAP was discussed earlier when we introduced the Norwalk Agreement, and is discussed in more detail in the following section.

18.8 EFFECT OF HARMONISATION ON COMPANIES

There are two main ways in which an individual country can harmonise its national GAAP with IFRS. It can require some or all entities (usually listed companies) to comply with IFRS from a particular date. Alternatively, it can converge its domestic standards with IFRS over a period of time, typically in stages. Obviously, the effect on individual companies is less dramatic and easier to manage if countries choose the second of these routes to harmonisation.

Where a company has to change from a national GAAP to IFRS on a particular date it has to deal with a number of practical issues. Typically, the main issues are as follows:

- Management, internal accounts staff and auditors need to be fully trained in IFRS. While there may be broad similarities between domestic standards and IFRS, there are frequently numerous differences in the detail.
- Accounting systems and information systems may need to be upgraded to deal with more complex or different reporting requirements.
- It is important to communicate with shareholders (particularly investors, lenders and their advisors) to prepare them for the possible effect of the change on the entity's reported results and financial position.
- The change to IFRS affects reported profits and net assets. Management remuneration may depend on a certain level of profits or on increases in profits. Debt covenants (agreements with lenders) may depend on a company maintaining a key level of assets to liabilities, or debt to equity. Remuneration schemes and debt covenants may need to be re-negotiated.
- IFRS disclosure requirements may be far more onerous than those of national GAAP. Preparers need to make sure that they have all the necessary information, bearing in mind that they will need to present at least one set of comparative figures under IFRS, as well as the figures for the current year.
- It may still be necessary to prepare accounts under national GAAP for the tax authorities.

A 2009 AASB publication *IFRS Adoption in Australia* summarised the outcomes of the change to IFRS from 2005. The benefits have been:

- Australian entities' financial reports are more readily understood world wide;
- there are synergies in the preparation, audit and analysis of Australian financial reports for entities that are part of a multinational group; and
- improved reporting of financial instruments (an area in which IFRS was more comprehensive than Australian GAAP).

The disadvantages have been:

- the initial costs of adoption, particularly for banks and insurers in implementing the standards on financial instruments;
- the pace of change: companies have had to deal with numerous amendments to IFRS that are often driven by issues that are not a concern in Australia; and
- accounting and reporting issues that are important to Australian companies (for example, for extractive industries) are not a priority for the IASB.

Case study: Reporting under IFRS

When companies adopt IFRS for the first time, they are required to include a reconciliation between profit after tax as previously reported and profit after tax under IFRS.

An extract from the financial statements of a retail group for the year ended 31 December 2005 (the first full year of applying IFRS) is shown below. The reconciliation statement is for the year ended 31 December 2004 (the previous year).

(b) Reconciliation of profit after tax between AGAAP (Australian Generally Accepted Accounting Principles) and AIFRS.

	Consolidated 31.12.04 $million	Parent Company 31.12.04 $million
Profit after tax attributed to Members as previously reported under AGAAP	832.9	347.7
Investment property revaluations (1)	2 298.1	–
Minority interest property revaluations (1)	(141.2)	–
Investment property revaluations attributable to equity accounted associates (1)	462.2	–
Deferred tax charge (1)	(358.4)	(29.0)
Goodwill on acquisitions (due to the recognition of deferred tax liabilities) written off (1)	(460.0)	–
Other AIFRS adjustments	(3.2)	(0.2)
Profit after tax attributable to members under AIFRS	2 630.4	318.5

(1) AASB 10 'Investment Property' requires revaluation increment/decrement to be recognised through the income statement. Under AGAAP revaluation movements were recognised in the asset revaluation reserve.

Profit for the year is significantly higher under IFRS than under Australian GAAP (AGAAP). This is because of the effect of IFRS on the group's investment properties (see the note to the statement). At this time, property prices were steadily rising.

Below is shown another reconciliation statement, this time from the financial statements of a telecommunications and media company for the year ended 30 June 2005 (this company's first full year of reporting under IFRS was the year to 30 June 2006). This company is in a different business from the retail group and the effect of adopting IFRS is not as pronounced. There is no one significant item, but a number of differences and the overall effect is to reduce profit for the year by $129 million (or by just under 3 per cent).

36. Adoption of International Financial Reporting Standards (continued)

(1) Reconciliation of profit under previous AGAAP to A-IFRS for the year ended 30 June 2005 for the Communications Entity.

		Communications Entity			
		Year ended 30 June 2005			
		Effect of transition to A-IFRS			
	Notes	Previous AGAAP $m	Presentation adjustments $m	Accounting adjustments $m	A-IFRS $m
Income					
Revenue (excluding finance income)	36(c),(d)	19,944	(336)	223	19,831
Other income	36(d)	–	133	–	133
		19,944	(203)	223	19,964
Expenses					
Labour	36(a),(f)	2,916	–	166	3,082
Goods and services purchased	37(k)	2,894	–	64	2,958
Other expenses	36(d),(e)(i)	3,666	(203)	15	3,478
		9,476	(203)	245	9,518
Earning before interest, income tax expense, depreciation and amortisation (EBITDA)		10,468	–	(22)	10,446
Depreciation and amortisation	36(b),(f),(h),(i)	3,298	–	(92)	3,206
Earnings before interest and income tax expense (EBIT)		7,170	–	70	7,240
Finance income	36(a)	103	–	(2)	101
Finance costs	36(h),(i)	851	–	92	943
Net finance costs		748	–	94	842
Profit before income tax expense		6,422	–	(24)	6,398
Income tax expense	36(c)	1,777	–	105	1,882
Profit for the year		4,645	–	(129)	4,516

19 DEVELOPMENTS IN INTERNATIONAL HARMONISATION

Section overview

- Although the IASB has faced criticism and political pressures, there is broad general support for its overall objective of implementing a single set of high quality, global financial reporting standards.

Arguably, the development of high quality International Financial Reporting Standards has been a major factor in making international harmonisation possible. International standards have to be perceived as at least as good as, or preferably better than, the national GAAP that they replace, otherwise they will not be accepted by the world's major stock exchanges.

This section looks at the progress that has been made towards harmonisation and the obstacles that still remain.

19.1 THE IASB AND IOSCO

The International Organisation of Securities Commissions (IOSCO) is the representative of the world's securities markets' regulators. High quality information is vital for the operation of an efficient capital market, and differences in the quality of the accounting policies and their enforcement between countries leads to inefficiencies between markets. IOSCO has been active in encouraging and promoting the improvement and quality of IFRS over the last 15 years. This commitment was evidenced by the agreement between the International Accounting Standards Committee (IASC) (the predecessor of the IASB) and IOSCO to work on a program of 'core standards' which could be used by publicly listed entities when offering securities in foreign jurisdictions.

The 'core standards' project resulted in 15 new or revised IFRS and was completed in 1999. IOSCO spent a year reviewing the results of the project and released a report in May 2000 which recommended to all its members that they allow multinational issuers to use IFRS, as supplemented by reconciliation, disclosure and interpretation where necessary to address outstanding substantive issues at a national or regional level.

IASB staff and IOSCO continue to work together to resolve outstanding issues and to identify areas where new IASB standards are needed. In June 2016 the IASB and IOSCO strengthened their cooperation by publishing a joint Statement of Protocols, the aim being the development and consistent application of international standards.

19.2 POLITICAL PROBLEMS

Any international body, whatever its purpose or activity, faces enormous political difficulties in attempting to gain **international consensus** and the IASB is no exception to this. How can the IASB reconcile the financial reporting situation between economies as diverse as third-world developing countries and sophisticated first-world industrial powers?

Developing countries are suspicious of the IASB, believing it to be dominated by the **US.** This arises because acceptance by the US listing authority, the Securities and Exchange Commission (SEC), of IFRS has been seen as a major hurdle to be overcome. For all practical purposes it is the American market which must be persuaded to accept IFRS and we discussed this earlier in this module when we briefly looked at the Norwalk Agreement. Developing countries have been catered for to some extent by the issue of a Standard on **agriculture**, which is generally of much more relevance to such countries.

There are also tensions between the **UK/US model** of financial reporting and the **European model**. The UK/US model is based around investor reporting, whereas the European model is mainly concerned with tax rules, so shareholder reporting has a much lower priority.

Although the EU countries have now adopted IFRS for the consolidated financial statements of listed entities, the Regulation actually requires listed companies to adopt the standards and Interpretations that have been **endorsed by the European Financial Reporting Advisory Group (EFRAG).** Many have feared that in practice this might lead to EFRAG effectively becoming a **European standard setting body** and that eventually Europe might **adopt its own variant of IFRS**. This has **not happened**.

The **global financial crisis** of 2008 intensified the above problems. Because IFRS requires most financial assets to be measured at fair value, entities had to record huge losses on remeasurement when share prices fell. Many argued that **the IASB had contributed to the crisis** by requiring the use of **fair values** (sometimes called 'mark to market' accounting). Some politicians, particularly within Europe, began to press the IASB to amend its financial instruments standards urgently so that companies would not have to recognise changes in the fair value of financial instruments in profit or loss. The IASB responded by accelerating its project to develop a new standard on financial instruments and this led to the issuing of IFRS 9, which has an effective adoption date of 1 January 2018, but has not retreated from its basic position, that is, that most financial assets should be measured at fair value.

Many also voiced **general criticisms** of the IASB and the IFRS Foundation that:

- it was not publicly accountable;
- its operating procedures were not sufficiently transparent and did not allow enough consultation; and
- it continued to be dominated by US interests and has prioritised convergence to US GAAP at the expense of other projects.

The IASB has responded to these criticisms by making some changes in its constitution and operating procedures. These include the following:

- A **Monitoring Board** has been set up to provide a **formal link between the Trustees and public capital market authorities**. The role of the Monitoring Board was described earlier in this module.
- The **composition of the IASB board** has changed. Originally, the IASB board had 14 members, of which 12 were full time and 2 were part time. Although most developed countries were represented, in practice over half the members came from North America. The IASB now has 12 members. As before, the members are appointed on the basis of their experience and technical expertise and are selected so that there is a mix of auditors, preparers of financial statements, users of financial statements and academics. Currently, there are three members from the Asia/Oceania region; three members from Europe; two members from North America; one member from Africa; one member from South America; and two members appointed from any area, subject to maintaining overall geographical balance.
- Three-yearly public consultations on the IASB's technical agenda have been introduced. The most recent of these consultations took place in 2015 and the results were announced on 2 November 2016. The IASB has taken account of these results in drawing up its current work program.
- A provision for accelerated due process has been introduced for use in exceptional circumstances.

Despite the criticisms, there is still broad general support for the IASB's overall objective of implementing a single set of high quality, global financial reporting standards.

19.3 THE EUROPEAN COMMISSION (EC) REGULATION

As we have already seen, the EC regulations form one part of a broader program for the harmonisation of company law in member states. The Commission is uniquely the only organisation to produce **international** standards of accounting practice that are legally enforceable, in the form of directives that must be included in the national legislation of member states. The directives have been criticised as they might become constraints on the application of world-wide standards and bring accounting standardisation and harmonisation into the political arena.

The EC adopted a regulation stating that **from 2005 consolidated accounts of listed companies are required to comply with IFRS.** The implications of this are far reaching.

Many commentators believe that, in the light of the above, it is only a matter of time before national standard-setting bodies are, in effect, replaced by the IASB and national standards fall into disuse. However, national standards were designed for the national environment, which may include small companies, the not-for-profit private sector and/or the public sector. Moreover, the IASB will need input and expertise from valued national standard-setters.

19.4 CONVERGENCE WITH US GAAP

Since 2002 there have been a variety of attempts to increase convergence of International and US accounting standards. Some standards have been issued jointly by the IASB and FASB, and since 2007 Companies listed on US stock exchanges but filing financial statements under IFRSs have not been required to prepare a reconciliation to US GAAP. However pressure within the US accounting community means that there is unlikely to be a move to IFRSs in the near future.

As discussed earlier in this module, in October 2004 the IASB and FASB agreed to develop a **common conceptual framework** which would be a significant step towards harmonisation of future standards.

Several chapters were released, but the remainder of the new *Conceptual Framework* will be developed by the IASB alone.

19.5 DIALOGUE WITH OTHER KEY STANDARD-SETTERS

The IASB maintains a policy of dialogue with other key standard-setters around the world, in the interest of harmonising standards across the globe.

National standard-setters are often involved in the development of Discussion Papers and Exposure Drafts on new areas. To ensure international representation, both the members of the IASB and the Trustees of the IFRS Foundation are to be taken from a broad geographical range which is specified: six from Asia/Oceania; six from Europe; six from North America; one from Africa; one from South America; and two from the rest of the world.

In addition, in 2013 the IFRS Foundation set up a new body, the Accounting Standards Advisory Forum (ASAF). This consists of national accounting standard setters and regional bodies with an interest in financial reporting. The purpose of the group is to provide technical advice and feedback to the IASB. The 12 members of the ASAF are chosen to ensure a broad geographical representation and balance of the major economic regions of the world and include the US FASB, the Australian Accounting Standards Board (AASB) and the UK Financial Reporting Council, as well as the standard-setting bodies from China and Japan and the Asian-Oceanian Standard Setters Group. The IFRS Trustees review membership of ASAF every two years.

19.6 THE SITUATION TODAY AND IN THE FUTURE

Many organisations committed to global harmonisation have done a great deal of work towards this goal. It is the case at present, however, that some disagreements still exist between countries and organisations about the way forward. One of the major inconsistencies is between the reporting requirements in developed countries and those in non-developed countries. It will be some time before these difficulties can be overcome. The IASB is likely to be the lead body in attempting to do so, as discussed above.

KEY MODULE POINTS 3

- A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.
- There are arguments for and against having accounting standards.
- **Going concern** is an underlying assumption in preparing financial statements.
- Financial information (other than information about cash flows) should be prepared on the **accruals** basis.
- Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.
- The two fundamental qualitative characteristics are: **relevance** and **faithful representation**.
- The four enhancing qualitative characteristics are: **comparability, verifiability, timeliness and understandability**.
- Although the IASB has faced criticism and political pressures, there is broad general support for its overall objective of implementing a single set of high quality, global financial reporting standards.

QUICK REVISION QUESTIONS 3

1 Which of the following is an advantage of a principles based system of accounting standard setting?
   A It always provides the answers.
   B It discourages creative accounting.
   C It results in greater comparability of financial statements.
   D It needs to be supported by illustrative examples and interpretations.

2 Which of the following statements are correct?
   I. Application of IFRS is presumed to result in financial statements that achieve a fair presentation.
   II. Under IFRS, all published financial statements are required to present fairly the financial position and financial performance of an entity.
   A I only
   B II only
   C both I and II
   D neither I nor II

3 Which of the following statements represents a disadvantage of the use of accounting standards?
   A Standards are a less rigid alternative to legislation.
   B Standards may tend towards rigidity in applying the rules.
   C Standards oblige companies to disclose their accounting policies.
   D Standards reduce variations in methods used to produce accounts.

4 According to the *Conceptual Framework,* which of the following is the **underlying assumption** relating to financial statements?
   A The information is free from material error or bias.
   B The accounts have been prepared on an accruals basis.
   C The business is expected to continue in operation for the foreseeable future.
   D Users are assumed to have sufficient knowledge to be able to understand the financial statements.

5 There are four enhancing qualitative characteristics of useful financial information. What are those characteristics?
   A going concern, accruals, completeness, verifiability
   B comparability, timeliness, verifiability, understandability
   C substance over form, neutrality, going concern, accruals
   D comparability, understandability, completeness, neutrality

6 Listed below are some comments on accounting concepts and useful financial information:
   I. Materiality means that only items having a physical existence may be recognised as assets.
   II. A faithful representation of financial information can never include amounts based on estimates.
   III. Financial information prepared using accrual accounting provides a better basis for assessing an entity's performance than information based only on cash flows.

   Which, if any, of these comments is correct, according to the IASB's *Conceptual Framework for Financial Reporting*?
   A I only
   B II only
   C III only
   D none of the above

7 What is the accounting concept called that requires income and expenses to be matched in the period in which they occur, rather than when the cash is received or paid?
   A accruals
   B neutrality
   C materiality
   D faithful representation

8 How many IFRS have been published by the IASB (excluding the IFRS for SMEs)?
   A 17
   B 29
   C 41
   D 43

9 Which of the following is a benefit of harmonisation?
   A ability of investors to compare cross border financial statements
   B increased training of staff to deal with new accounting standards
   C amendment of tax systems in different countries to align with accounting requirements
   D different countries have different legal systems for accounting which need to be amended

10 With which accounting body has the IASB carried out a joint project to develop several common accounting standards?
   A the OECD
   B the Standards Advisory Council
   C the Financial Accounting Standards Board
   D the Australian Accounting Standards Board

20 THE ELEMENTS OF FINANCIAL STATEMENTS

LO 1.6

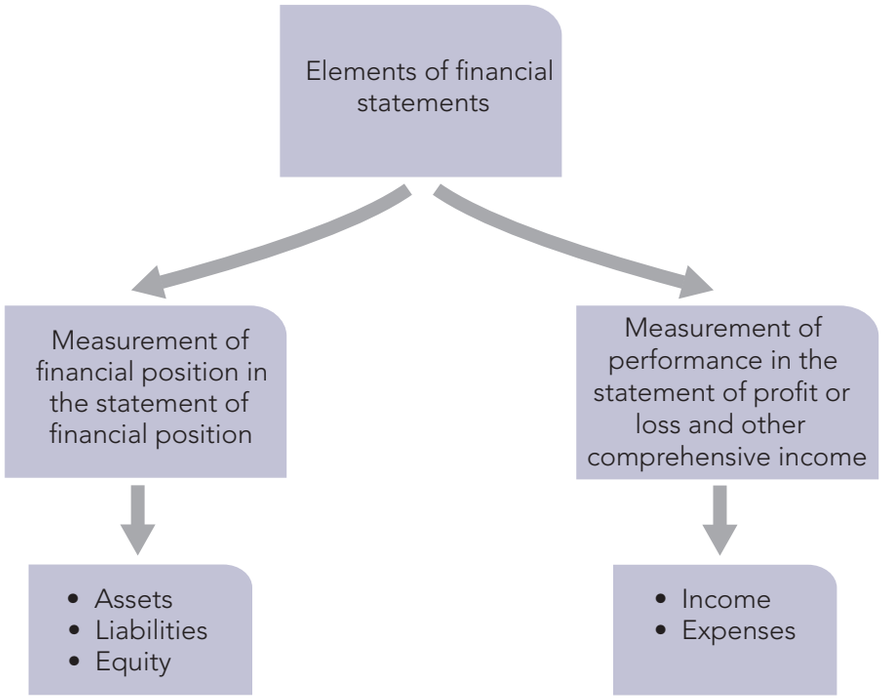
Section overview

- Transactions and other events are grouped together in broad **classes** and in this way their financial effects are shown in the financial statements. These broad classes are the **elements** of financial statements.

20.1 SUBJECT OUTLINE

Earlier in this module, we discussed the principles of the IASB's *Conceptual Framework for Financial Reporting*. This section looks at some of the detail within the *Conceptual Framework* and examines the definitions of the elements of financial statements.

The *Conceptual Framework* sets out these elements as follows:



A process of **sub-classification** then takes place for presentation in the financial statements, for example, assets are classified by their nature or function in the business to show information in the best way for users to make economic decisions.

20.2 FINANCIAL POSITION

We need to define the three terms listed under this heading above.

Definitions

Asset. A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

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

Equity. The residual interest in the assets of the entity after deducting all its liabilities.

(Conceptual Framework)

These definitions are important, but they do not cover the **criteria for recognition** of any of these items, which are discussed in the next section of this module. This means that the definitions may include items which would not actually be recognised in the statement of financial position because they fail to satisfy recognition criteria particularly, as we will see below, the **probable flow of any economic benefit** to or from the business.

Whether an item satisfies any of the definitions above will depend on the **substance and economic reality** of the transaction, not merely its legal form as discussed earlier.

20.3 ASSETS

We can look in more detail at the components of the definitions given above.

Definition

Future economic benefit. The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production. *(Conceptual Framework)*

Assets are usually employed to produce goods or services for customers; customers will then pay for these, so resulting in future economic benefit.

The existence of an asset, particularly in terms of **control**, is not reliant on:

(a) **physical form** (hence patents and copyrights are assets); nor

(b) **legal rights** (hence leases can give rise to assets).

Transactions or events **in the past** give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

20.4 LIABILITIES

Again we can look more closely at some aspects of the definition. An essential characteristic of a liability is that the entity has a **present obligation**.

Definition

Obligation. A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. *(Conceptual Framework)*

It is important to distinguish between a present obligation and a **future commitment**. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation. An obligation is something that **cannot be avoided**.

Settlement of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash.

Liabilities must arise from **past transactions or events**. For example, in the recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.

20.4.1 PROVISIONS

Companies may include provisions, for example, for legal damages or warranty obligations, in their financial statements. Is a provision a liability?

Definition

Provision. A present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated. *(Conceptual Framework)*

Question 13: Asset or liability?

Consider the following situations. In each case, does the company have an asset or liability within the definitions given by the *Conceptual Framework?* Give reasons for your answer.

(a) Pat Co. has purchased a patent for $20 000. The patent gives the company sole use of a particular manufacturing process which will save $3000 a year for the next 5 years.

(b) Baldwin Co. paid a mechanic $10 000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.

(c) Deals on Wheels Co. announces that it will pay all of its staff a bonus.

(The answer is at the end of the module.)

20.5 EQUITY

Equity is defined above as a **residual**, but it may be sub-classified in the statement of financial position into different equity reserves. The amount shown for equity depends on the **measurement of assets and liabilities.** This is discussed in more detail later in this module.

20.6 FINANCIAL PERFORMANCE

Profit is used as a **measure of performance**, or as a basis for other measures (e.g. earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital (the amount invested in a business by its owners) and capital maintenance adopted (see Module 2).

The elements of income and expenses are therefore defined.

Definitions

Income. Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Expenses. Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. *(Conceptual Framework)*

Income and expenses can be **presented in different ways** in the financial statements to provide information relevant for economic decision-making. For example, a distinction is made between income and expenses which relate to continuing operations and those which do not.

20.7 INCOME

Both **revenue** and **gains** are included in the definition of income. **Revenue** arises in the course of ordinary activities of an entity.

Definition

Gains. Increases in economic benefits. As such they are no different in nature from revenue.

(Conceptual Framework)

Gains include those arising on the disposal of non-current assets. The definition of income also includes **unrealised gains**, for example, on revaluation of marketable securities. These are gains which have not yet been realised because the securities have not yet been sold at the increased price.

20.8 EXPENSES

As with income, the definition of **expenses** includes losses as well as those expenses that arise in the course of ordinary activities of an entity.

Definition

Losses. Decreases in economic benefits. As such they are no different in nature from other expenses.

(Conceptual Framework)

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealised losses**, for example, downward revaluation of property, unrealised because the property has not been sold at the reduced value.

20.9 CAPITAL MAINTENANCE ADJUSTMENTS

Definition

Capital maintenance adjustments. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. *(Conceptual Framework)*

IFRSs allow or require certain assets to be measured at fair value in the financial statements. Such assets are remeasured periodically in accordance with the requirements of relevant IFRS, to ensure that an up to date fair value is reflected.

This periodic revaluation, or restatement, of an asset's carrying amount may be either upwards or downwards, so resulting in either a gain (income) or a loss (expense).

The gain or loss is **not included** in an entity's profit or loss for the year under certain concepts of capital maintenance. Instead it is shown as 'other comprehensive income'. Other comprehensive income includes items of income or expense which are not permitted to be included in profit or loss for the year, but which do meet the definition of income and expenses and result in an increase or decrease in equity.

21 RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS

LO 1.6

Section overview

- Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.

Definition

Recognition. The process of incorporating into the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

- it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- the item has a cost or value that can be measured with reliability. *(Conceptual Framework)*

Regard must also be given to **materiality** as defined in the *Conceptual Framework*.

Definition

Materiality. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. *(Conceptual Framework)*

21.1 PROBABILITY OF FUTURE ECONOMIC BENEFITS

Probability here means the **degree of uncertainty** that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the **characteristics of the entity's environment** and the **evidence available** when the financial statements are prepared.

21.2 RELIABILITY OF MEASUREMENT

The cost or value of an item, in many cases, **must be estimated**. The *Conceptual Framework* states, however, that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition **at a later date** due to changes in circumstances or subsequent events.

21.3 RECOGNITION OF ITEMS

We can summarise the recognition criteria for assets, liabilities, income and expenses, based on the definition of recognition given above.

ITEM	RECOGNISED IN	WHEN
Asset	The statement of financial position	It is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
Liability	The statement of financial position	It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
Income	The statement of profit or loss and other comprehensive income	An increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably, other than those relating to contributions from equity participants
Expenses	The statement of profit or loss and other comprehensive income	A decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably, other than those relating to distributions to equity participants

22 APPLYING THE RECOGNITION CRITERIA

LO 1.6

Section overview

- The *Conceptual Framework for Financial Reporting* sets out criteria that should be applied in determining whether to recognise assets, liabilities, equity, income or expenses in the financial statements.

22.1 ASSETS

The *Conceptual Framework* explains that an asset is not recognised in the statement of financial position when expenditure has been incurred but it is considered not probable that economic benefits will flow to the entity beyond the current accounting period. Instead, an expense is recognised.

Consider the case of advertising expenditure. The company incurs the cost of having its products and services advertised because management believes that increased sales revenue will result. It could be argued that the advertising meets the definition of an asset: it is a resource controlled by the entity as the result of a past transaction (the contract with the agency and the payment of the fee) and economic benefit is expected to flow to the entity as a result (in the form of increased sales revenue). But the cost of the advertising cannot be capitalised (recognised as an asset), because it fails at least one and probably both of the recognition criteria:

- It is certainly possible that the entity will obtain economic benefit from the expenditure in a future period, but it would normally be quite difficult to argue that an increase in revenue is probable. Even if there is a pattern of increased sales following an advertising campaign, it would be very difficult to prove that a certain number of customers bought a particular product or a service just because they had seen an advert for it (although that may have been a factor, possibly a subconscious one, in their decision).
- In the same way, it would be very difficult to prove that X amount of advertising expenditure resulted in Y amount of additional sales revenue. Therefore the 'asset' does not have a cost that can be measured reliably.

Question 14: Research and development expenditure

Below is an extract from the annual report of a retail group.

Significant Accounting Policies

Research and development

Expenditure on research activities, undertaken with the prospect of gaining new technical knowledge and understanding, is recognised in the profit and loss as an expense as incurred.

Expenditure on development activities, whereby research findings are applied to a plan or design for the production of new or substantially improved products and processes, is capitalised if the product or process is technically and commercially feasible and the consolidated entity has sufficient resources to complete development. The expenditure capitalised includes the cost of materials, direct labour and an appropriate proportion of overheads.

Other development expenditure is recognised in the income statement as an expense as incurred. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses.

Required

Explain the reasoning behind these accounting policies.

(The answer is at the end of the module.)

22.2 LIABILITIES

A liability is recognised in the statement of financial position when:

- it is **probable** that an outflow of resources embodying economic benefits will result from the settlement of a present obligation; and
- the amount at which the liability will be settled can be **measured reliably**.

There are two considerations here: deciding whether an outflow is probable; and estimating the amount of the liability.

Consider a possible liability arising from a claim against a company. One of its customers has been seriously injured, allegedly as the result of buying and using the company's products. For there to be a

liability, there must be a present obligation to pay damages as a result of a past event (the purchase and use of the products). At the year-end, lawyers advise that there is approximately an 80 per cent chance that the company will be found liable. It is **more likely than not** that the company will have to pay compensation, which will amount to between $50 000 and $100 000.

In this case, there is a liability and it meets the first of the recognition criteria: it is **probable** that there will be an outflow of economic benefit. Because the lawyers have been able to determine a range of possible outcomes the second recognition criteria is met: the amount of the liability **can be measured reliably**.

The company **recognises a provision** (a liability of uncertain timing or amount) for the best estimate of the amount to settle the obligation.

Question 15: Legal claim

A customer is making a claim against a company. At the year-end, the company's lawyers advise that there is approximately a 40 per cent chance that the company will be found liable and will have to pay compensation.

Required

Explain how you would treat the claim in the financial statements for the period.

(The answer is at the end of the module.)

22.3 EQUITY

The *Conceptual Framework* defines equity as the residual interest in the assets of the entity after deducting all its liabilities. This is a restatement of the basic accounting equation:

ASSETS – LIABILITIES = EQUITY

Equity consists of funds contributed by shareholders (share capital), retained earnings and other reserves. Other reserves are normally appropriations of retained earnings.

Equity can be viewed as a type of liability: the amount owed to the equity shareholders (its owners). However, there is a crucial difference between equity and liabilities. For there to be a liability there must be an **obligation**: an outflow of economic benefits that cannot realistically be avoided.

Many companies are financed by a mixture of equity and debt (borrowings).

- Debt finance is a **liability** of the company. The company will eventually have an **obligation to repay the amount**. In almost all cases, the company also has an **obligation to pay interest** on its debt, regardless of the amount of the entity's profits or losses. There is normally reasonable certainty about the amount that the lenders will receive and about when they will receive it.
- Share capital gives their holders the right to **share in the company's profit and losses** and (in theory) to influence the policies adopted by management by exercising voting rights. They are **exposed to the risks** and uncertainties of the business. The return on their investment (in the form of dividends) **depends on the company's results**; in a poor year they may receive nothing. If the company is wound up, they may receive a share of its retained profits, but only after the lenders and other creditors have been paid.

During the last thirty years there has been a growth in the number and complexity of types of financial instrument. For legal reasons, some instruments are called shares although they have the characteristics of debt. Preparers of financial statements should look at the economic substance of the arrangement in order to decide whether a financial instrument is debt (a liability) or equity.

Question 16: Preference shares

A company has two classes of shares: ordinary shares and 6 per cent redeemable preference shares which were issued at $1 each. Holders of the preference shares receive a dividend of 6 per cent of the amount of their shareholding each year. For example, a shareholder who held 10 000 preference shares would automatically receive a dividend of $600 each year, regardless of the company's performance. The preference shares mature in five years' time: at that date the capital that the holders have invested will be repaid to them.

Required

Are the preference shares part of equity, or a liability? Explain your answer.

(The answer is at the end of the module.)

22.4 INCOME

The *Conceptual Framework* explains that income is recognised when:

- there has been an increase in future economic benefits related to an **increase in an asset** or a **decrease of a liability**; and
- this increase or decrease can be **measured reliably**.

For example, when an entity makes a sale it recognises revenue and it also recognises an asset: cash or an amount receivable that will eventually be converted into cash. This asset meets the recognition criteria:

- it is probable that there will be an inflow of economic benefit (cash has either already been received or will be received in the near future); and
- the amount can be reliably measured (it is normally a matter of fact and can be verified).

Similarly, when an entity recognises a gain on disposal of an asset it also recognises a net increase in assets: tangible assets decrease, but cash increases by a greater amount.

Determining **when** to recognise revenue can sometimes be a problem. Even a simple sales transaction has several stages: the customer orders the goods; the goods are produced; the goods are delivered to the customer; the customer is invoiced; and the cash is received. In theory, a company could argue a case for recognising a sale at any of these stages, but generally accepted accounting practice is to recognise the revenue when the goods are despatched to the customer. This is the **critical event** in the earnings cycle. At this point the company has **performed** its side of the sales contract with the customer and has earned the right to payment. Control of the asset has been transferred to the customer.

When it is a service that is sold, revenue is recognised as or when the service is performed. For example, revenue from a magazine subscription is recognised over the period of the subscription.

In recent years, there have been several occasions on which companies have adopted controversial accounting policies for revenue recognition (sometimes called 'aggressive earnings management'). These controversial policies have all involved recognising revenue before it has actually been earned.

Question 17: Airline

Below is an extract from the annual report of an international airline group:

> **Statement of significant accounting policies: Revenue Recognition**
>
> **Passenger, Freight and Tours and Travel Revenue**
>
> Passenger, freight and tours and travel revenue is recognised when passengers or freight are uplifted or when tours and travel air tickets and land content are utilised. Unused tickets are recognised as revenue using estimates based on the terms and conditions of the ticket.

Required

Explain the reasoning behind this accounting policy by applying the recognition criteria in the *Conceptual Framework*.

(The answer is at the end of the module.)

22.5 EXPENSES

The *Conceptual Framework* explains that expenses are recognised when:

(a) there has been a decrease in future economic benefits related to a **decrease in an asset** or an **increase in a liability**; and

(b) this increase or decrease can be **measured reliably**.

For example, when an entity incurs office expenses such as light and heat, it recognises the expense and it also recognises a liability: the amount payable to the supplier. This liability meets the recognition criteria:

- it is probable that there will be an outflow of economic benefits (the entity must eventually pay the amount it owes to the supplier); and
- the amount can be reliably measured (the amount payable will either have been invoiced or can be estimated based on past experience).

Expenses are recognised in profit or loss on the basis of a direct association between the costs incurred and the earning of specific items of income (the matching of costs and revenues). Applying the matching concept should not result in the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities.

Where economic benefits are expected to arise over several accounting periods, expenses are allocated to accounting periods in a systematic and rational way. For example, property, plant and equipment is depreciated in order to match the expense of acquiring it to the income which it generates. The expense is recognised in the accounting periods in which the economic benefits associated with it are consumed.

When expenditure produces no future economic benefits an expense should be recognised immediately in profit or loss. An expense is also recognised when a liability is incurred without the recognition of an asset.

Question 18: Restoration costs

A mining company is legally obliged to restore the site and to rectify environmental damage after each mine is closed. Typically, a mine is expected to operate for at least 20 years. Approximately 40 per cent of the eventual expense relates to the removal of mineshafts and the rectification of damage that occurs when the mine is originally sunk, the remainder of the cost relates to damage that is caused progressively as the minerals are extracted.

During the current reporting period the company has sunk a mineshaft but not yet commenced extracting minerals.

According to the *Conceptual Framework*, how should this event be reported in the financial statements for the current period and subsequent periods?

(The answer is at the end of the module.)

23 THE MAIN FINANCIAL STATEMENTS

Section overview

- The principal financial statements of a business are the **statement of financial position** and the **statement of profit or loss and other comprehensive income**.

23.1 STATEMENT OF FINANCIAL POSITION

Definition

The statement of financial position is simply a **list** of all the **assets owned and/or controlled** and all the **liabilities owed** by a business as at a particular date. It is a snapshot of the financial position of the business at a particular moment. Monetary amounts are attributed to each of the assets and liabilities.

23.1.1 ASSETS

Examples of assets are factories, office buildings, warehouses, delivery vans, lorries, plant and machinery, computer equipment, office furniture, amounts owing from customers (receivables), cash and goods held in store awaiting sale to customers.

Some assets are held and used in operations for a long time. An office building is occupied by administrative staff for years; similarly, a machine has a productive life of many years before it wears out. These types of assets are called **non-current assets**.

Other assets are held for only a short time. The owner of a newspaper shop, for example, has to sell their newspapers on the same day that they get them. The more quickly a business can sell the goods it has in store, the more profit it is likely to make; provided, of course, that the goods are sold at a higher price than what it cost the business to acquire them. These are **current assets**.

Current/non-current distinction

An entity must present **current** and **non-current** assets as separate classifications on the face of the statement of financial position.

23.1.2 LIABILITIES

Examples of liabilities are amounts owed to a supplier for goods purchased on credit, amounts owed to a bank (or other lender), a bank overdraft and amounts owed to tax authorities (e.g. in respect of sales tax/GST).

Some liabilities are due to be paid fairly quickly for example, amounts payable to suppliers. Other liabilities may take some years to repay (e.g. a bank loan).

Current/non-current distinction

The categorisation of current liabilities is very similar to that of current assets.

23.1.3 CAPITAL OR EQUITY

The amounts invested in a business by the owner, together with the retained profits of the business, are amounts that the business owes to the owner. These are known as capital or equity. In a limited liability company, capital introduced usually takes the form of shares. Equity may be thought of as the owner's stake in the net assets of the business, but note that this would only be paid to the owner (less liquidation costs) in the unlikely event of the business winding up.

23.1.4 FORM OF STATEMENT OF FINANCIAL POSITION

A statement of financial position may also be called a balance sheet. This name is appropriate because assets will always be equal to liabilities plus equity. An example of a statement of financial position for a company is shown below.

XYZ – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER

	20X7 $'000	20X6 $'000
Assets		
Non-current assets		
Property, plant and equipment	450 850	470 790
Goodwill	80 800	91 200
Other intangible assets	227 470	227 470
Financial assets	142 500	156 000
	901 620	945 460
Current assets		
Inventories	135 230	132 500
Trade receivables	91 600	110 800
Other current assets	25 650	12 540
Cash and cash equivalents	312 400	322 900
	564 880	578 740
Total assets	1 466 500	1 524 200
Equity and liabilities		
Share capital	650 000	600 000
Retained earnings	313 550	210 300
Other components of equity	10 200	21 200
Total equity	973 750	831 500
Non-current liabilities		
Long-term borrowings	120 000	160 000
Deferred tax	28 800	26 040
Long-term provisions	28 850	52 240
Total non-current liabilities	177 650	238 280
Current liabilities		
Trade and other payables	115 100	187 620
Short-term borrowings	150 000	200 000
Current portion of long-term borrowings	10 000	20 000
Current tax payable	35 000	42 000
Short-term provisions	5 000	4 800
Total current liabilities	315 100	454 420
Total liabilities	492 750	692 700
Total equity and liabilities	1 466 500	1 524 200

Case study: Statement of financial position

The consolidated statement of financial position of Wesfarmers Ltd Group at 30 June 2012 is shown below. This is presented in a different order from the illustration above, but notice that it still clearly shows the three elements defined in the *Conceptual Framework* and the relationship between them: ASSETS less LIABILITIES equals EQUITY. Many Australian companies present their statements of financial position in the order used by Wesfarmers.

Notice also that it clearly analyses assets and liabilities between current items and non-current items.

Balance sheet

as at 30 June 2012 – Wesfarmers Limited and its controlled entities

	Note	CONSOLIDATED 2012 $m	2011 $m
ASSETS			
Current assets			
Cash and cash equivalents	8	**1,127**	897
Trade and other receivables	9	**2,384**	2,149
Inventories	10	**5,006**	4,987
Derivatives	27	**164**	184
Investments backing insurance contracts, reinsurance and other recoveries	11	**1,690**	1,543
Other	12	**540**	458
Total current assets		**10,911**	10,218
Non-current assets			
Receivables	9	**33**	9
Available-for-sale investments	13	**15**	17
Investment in associates	14	**429**	471
Deferred tax assets	5	**475**	437
Property	15	**2,631**	2,148
Plant and equipment	15	**6,832**	6,154
Intangible assets	16	**4,393**	4,353
Goodwill	16	**16,097**	16,227
Derivatives	27	**233**	233
Investments backing insurance contracts, reinsurance and other recoveries	11	**193**	471
Other	17	**70**	76
Total non-current assets		**31,401**	30,596
Total assets		**42,312**	40,814
LIABILITIES			
Current liabilities			
Trade and other payables	18	**5,420**	5,059
Interest-bearing loans and borrowings	19	**1,621**	266
Income tax payable		**455**	345
Provisions	20	**1,289**	1,166
Insurance liabilities	21	**1,635**	1,532
Derivatives	27	**126**	96
Other	22	**201**	258
Total current liabilities		**10,747**	8,722
Non-current liabilities			
Payables	18	**20**	24
Interest-bearing loans and borrowings	19	**3,881**	4,613
Provisions	20	**1,206**	1,092
Insurance liabilities	21	**682**	803
Derivatives	27	**116**	208
Other	22	**33**	23
Total non-current liabilities		**5,938**	6,763
Total liabilities		**16,685**	15,485
Net assets		**25,627**	25,329
EQUITY			
Equity attributable to equity holders of the parent			
Issued capital	23	**23,286**	23,286
Employee reserved shares	23	**(31)**	(41)
Retained earnings	24	**2,103**	1,774
Reserves	25	**269**	310
Total equity		**25,627**	25,329

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23.2 STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Definition

A statement of profit or loss and other comprehensive income is a **record** of **income generated** and **expenditure incurred** over a given period. The statement shows whether the business has had more income than expenditure (a profit) or more expenditure than income (loss).

The statement of profit or loss and other comprehensive income shows, as the name suggests:

- profit or loss for the period; and
- other comprehensive income.

Together profit or loss and other comprehensive income give total comprehensive income and this statement may also be referred to as the statement of comprehensive income.

23.2.1 INCOME AND EXPENSES

Income within the statement of profit or loss and other comprehensive income is the income earned within a period. The **expenses** are the costs of running the business for the same period.

23.2.2 OTHER COMPREHENSIVE INCOME

Certain items of income and expense do not form profit or loss for the year, and instead are recognised as other comprehensive income. IAS 1 and other IFRSs specify the items which this applies to, and requires that these are sub-classified according to whether they may be reclassified to profit or loss at a future date.

23.2.3 FORM OF STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

The period chosen will depend on the purpose for which the statement is produced. The statement of profit or loss and other comprehensive income which forms part of the published annual financial statements of a **limited liability company** will usually be for the period of a **year**, commencing from the date of the previous year's statements. On the other hand, **management** might want to keep a closer eye on a company's profitability by making up **quarterly or monthly** statements from a management accounting perspective.

The statement of profit or loss and other comprehensive income may be shown as a single statement or in two statements. The example below shows the 'single statement approach', starting with revenue and ending with total comprehensive income. The alternative approach includes:

1. a statement of profit or loss, showing line items from revenue to profit or loss for the year; and
2. a second statement, the statement of comprehensive income, showing profit for the year (i.e. the total from 1 above) and items of other comprehensive income to give total comprehensive income.

XYZ – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7 $'000	20X6 $'000
Revenue	415 000	375 000
Cost of sales	(245 000)	(230 000)
Gross profit	170 000	145 000
Other income	17 767	16 400
Distribution costs	(9 000)	(8 700)
Administrative expenses	(20 000)	(21 000)
Other expenses	(2 100)	(1 200)
Finance costs	(8 000)	(7 500)
Profit before tax	148 667	123 000
Income tax expense	(30 417)	(27 000)
Profit for the year from continuing operations	118 250	96 000
Loss for the year from discontinued operations	–	(30 500)

	20X7 $'000	20X6 $'000
Profit for the year	118 250	65 500
Other comprehensive income:		
Remeasurement of financial assets	(14 000)	20 000
Gains on property revaluation	3 000	8 000
Other comprehensive income for the year	(11 000)	28 000
Total comprehensive income for the year	107 250	93 500

Case study: Statement of profit or loss and other comprehensive income

The statement profit or loss of Wesfarmers Ltd Group for the year ended 30 June 2012 is shown below. Wesfarmers presents two separate statements of financial performance: an income statement and a statement of comprehensive income. Only the income statement is shown here.

Notice that Wesfarmers analyses items of income and expenses according to their **nature**. The illustration above analyses expenses by their **function**. But the statement still clearly shows the two elements: income and expenses.

Income statement

for the year ended 30 June 2012 – Wesfarmers Ltd Group and its controlled entities

	Note	CONSOLIDATED 2012 $m	 2011 $m
Revenue			
Sale of goods		**55,897**	52,891
Rendering of services		**1,788**	1,622
Interest – other		**144**	145
Other		**251**	217
		58,080	54,875
Expenses			
Raw materials and inventory		**(38,406)**	(36,515)
Employee benefits expense	4	**(7,496)**	(7,116)
Net insurance claims, reinsurance and commissions		**(1,413)**	(1,283)
Freight and other related expenses		**(946)**	(895)
Occupancy-related expenses	4	**(2,232)**	(2,151)
Depreciation and amortisation	4	**(995)**	(923)
Impairment expenses	4	**(197)**	(27)
Other expenses	4	**(3,213)**	(2,977)
		(54,898)	(51,887)
Other income	4	**383**	259
Finance costs	4	**(505)**	(526)
Share of losses of associates	14	**(16)**	(15)
Profit before income tax		**3,044**	2,706
Income tax expense	5	**(918)**	(784)
Profit attributable to members of the parent		**2,126**	1,922
Earnings per share (cents per share)	6		
– basic for profit for the period attributable to ordinary equity holders of the parent		**184.2**	166.7
– diluted for profit for the period attributable to ordinary equity holders of the parent		**183.9**	166.3

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23.3 OTHER FINANCIAL STATEMENTS

The statement of financial position and the statement of profit or loss and other comprehensive income form the basis of the financial statements of most businesses.

In Module 3, we will explain how to prepare a statement of financial position and a statement of profit or loss and other comprehensive income for a limited liability company in accordance with IAS 1 *Presentation of Financial Statements*. Under IFRS, limited liability companies are also required to prepare a **statement of changes in equity** and a **statement of cash flows,** as well as notes to the financial statements.

23.3.1 STATEMENT OF CHANGES IN EQUITY

The statement of changes in equity shows the movements in the various components of equity (share capital, retained earnings and other reserves) for a period. The purpose of the statement is to show the transactions between the company and its owners. These consist of:

- total comprehensive income for the year, made up of the profit or loss for the year (changes in retained earnings), plus other comprehensive income (items such as revaluation gains which are not included in profit or loss, but recognised in a separate reserve within equity);
- contributions from owners: issues of shares; and
- distributions to owners: dividends paid.

An example of a simple statement of changes in equity is shown below.

XYZ – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	Retained earnings	Other components of equity	Total
	$'000	$'000	$'000	$'000
Balance at 1 Jan 20X7	600 000	210 300	21 200	831 500
Changes in equity for 20X7				
Issue of share capital	50 000	–	–	50 000
Dividends	–	(15 000)	–	(15 000)
Total comprehensive income for the year	–	118 250	(11 000)	107 250
Balance at 31 Dec 20X7	650 000	313 550	10 200	973 750

The preparation of a statement of changes in equity is covered in Module 3.

23.3.2 STATEMENT OF CASH FLOWS

The statement of cash flows shows all movements of cash and cash equivalents into and out of a business during the accounting period. These cash flows are classified into operating, investing and financing activities. The cash flows for each of these are totalled to give the net inflow or outflow of cash for the period.

The statement of cash flows is covered in more detail in Module 3.

Question 19: Accounting information

The financial statements of a limited liability company will consist solely of the statement of financial position and statement of profit or loss and other comprehensive income.

This statement is

A correct.

B not correct.

(The answer is at the end of the module.)

KEY MODULE POINTS 4

- Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.
- Financial position is shown by:
  - assets
  - liabilities
  - equity.
- Financial performance is shown by:
  - income
  - expenses.
- Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain recognition criteria:
  - it is probable that any future economic benefit associated with the item will flow to or from the entity; and
  - the item has a cost or value that can be measured reliably.
- The principal financial statements of a business are the statement of financial position and the statement of profit or loss and other comprehensive income. Other statements include the statement of changes in equity and the statement of cash flows.

QUICK REVISION QUESTIONS 4

1 Of what is the following statement a definition?

'A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.'

A asset
B equity
C liability
D expense

2 Which of the following is the correct definition of a liability?

A the residual interest in the assets of the entity after deducting all its liabilities
B a present obligation arising from past events from which future economic benefits are expected to flow to the entity
C a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity
D a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits

3 What are the criteria for recognition of items in the financial statements according to the IASB's *Conceptual Framework*?

A probable that future economic benefit will flow to or from the entity
B probable that there will be outflow of future economic benefits and there is a past transaction
C probable that there will be an inflow or outflow of future economic benefits and there is a past transaction
D probable that future economic benefit will flow to or from the entity and the item can be measured with reliability

4 What items are recognised in the statement of profit or loss and other comprehensive income?

I. equity
II. assets
III. income
IV. liabilities
V. expenses

A III only
B I and V only
C III and V only
D I, II, III, IV and V

5 Which of the following is an example of a current asset?

A retained earnings
B manufacturing licences
C property, plant and equipment
D motor vehicles held for sale as part of a trade

6 Which of the following items are non-current assets?

I. land
II. inventory
III. bank loan
IV. machinery

A I only
B I and IV only
C I, III and IV only
D II, III and IV only

7 How is a bank overdraft classified in the statement of financial position?

A current asset
B current liability
C non-current asset
D non-current liability

8 How should the balance of accounts payable be reported in the financial statements?

A as an expense
B as a current asset
C as a current liability
D as a non-current asset

9 Which of the following is an example of a liability?

A loan
B inventory
C receivables
D plant and machinery

ANSWERS TO QUICK REVISION QUESTIONS 1

1 D The primary aim of accounting is to provide financial information for users.

2 C Lenders and shareholders in particular are identified as the primary users of financial statements. Information produced with them in mind should also be useful for other user groups, however these other groups are not considered to be the main audience of financial accounts.

3 D Although shareholders need to know the future prospects, they also need to know that the current position of the company is secure. Similarly, suppliers need to know the future prospects to ensure that they will be paid.

4 A The International Accounting Standards Committee is the old name of the IASB; the IASB is overseen by and accountable to the IFRS Foundation.

5 D The IFRS Foundation appoints the members of the IASB; the IFRS Interpretations Committee issues Interpretations; and the IFRS Foundation oversees the work of the IFRS Interpretations Committee.

6 B The IASB has no powers of enforcement.

7 C The IFRS Interpretations Committee interprets the application of IFRS and provides guidance on topics not specifically covered by an IFRS.

8 D GAAP is all the rules and regulations a company must follow so can include national as well as international standards.

9 B A, C and D are all perceived as disadvantages of the regulation of company financial statements: more disclosure is required; the extra work involved in adhering to regulations is costly and competitors have access to more information which they may use to their advantage. Regulation does, however, result in higher quality, more comparable, relevant and faithfully represented information.

10 D Although the issue of a discussion paper is not a mandatory step in due process, this would be issued before the (mandatory) exposure draft, and in due course a final standard.

ANSWERS TO QUICK REVISION QUESTIONS 2

1 D A conceptual framework is sometimes referred to as a 'guiding light' which underpins accounting standards.

2 A The framework provides the principles which underpin IFRS; in addition its principles are applied where no standard exists. Therefore all transactions are effectively accounted for in line with the framework, so resulting in standardised accounting practice.

3 B The *Conceptual Framework for Financial Reporting* is the name of the IASB's conceptual framework.

4 B All are valid reasons that financial statements are produced, but the key reason is B.

5 D They are all uses of the financial statements.

6 A Existing and potential investors, lenders and other creditors (providers of capital).

7 D The underlying principles contained within the conceptual framework should be applied.

8 D I is a change of accounting estimate, III is specifically mentioned in IAS 8 as not constituting a change of accounting policy.

9 A Material errors are treated in the same way as changes of accounting policy. They are corrected retrospectively, so that the financial statements are presented as if the error had never occurred.

ANSWERS TO QUICK REVISION QUESTIONS 3

1 B A principles based system discourages 'creative accounting' abuses. Principles are harder to evade than rules. Many people believe that A and C are advantages of a rules based system. D is often true of principles based standards, but many view this as a disadvantage.

2 C All published financial statements must be fairly presented (or show a true and fair view). Application of IFRS is presumed to result in a fair presentation (although additional disclosures may be necessary).

3 B The other arguments are all in favour of accounting standards.

4 C The underlying assumption is going concern.

5 B These are the four qualitative characteristics contained within the Conceptual Framework which enhance the usefulness of information that is relevant and faithfully represented.

6 C Materiality concerns whether an item in the financial statements can influence users' decisions. A faithful representation must be free from error, but this does not mean perfectly accurate in all respects.

7 A The accruals concept requires that the effects of transactions are recognised when they occur, so meaning that credit sales and purchases, for example, are included in profit or loss for a period.

8 A 16 IFRS have been published by the IASB.

9 A Investors will benefit as financial statements will be more comparable.

10 C The FASB is the US standard setter. It has worked with the IASB on a number of projects, including new standards on business combinations, fair value measurement, financial instruments and revenue recognition.

ANSWERS TO QUICK REVISION QUESTIONS 4

1 A This is the definition of an asset contained within the *Conceptual Framework* and various IFRS.

2 D This is the definition of a liability contained within the *Conceptual Framework* and various IFRS. A is the definition of equity; C is the definition of an asset; B is a mixture of the definitions of a liability and an asset.

3 D There are two elements to the recognition criteria: a probable flow of economic benefits and reliable measurement. The 'past event' criteria forms part of the definitions of an asset and liability and is not repeated within the recognition criteria.

4 C Assets, liability and equity are included in the statement of financial position.

5 D Motor vehicles are generally a non-current asset, however motor vehicles held for sale as part of a trade are current assets in accordance with IAS 2 *Inventories*. Property, plant and equipment and licences are non-current assets of a business; retained earnings are part of the equity in a business.

6 B A bank loan is a liability of a business and inventory is a current asset.

7 B An overdraft is classed as current, even where there is a rolling facility, as it is repayable on demand.

8 C Payable accounts are part of the normal operating cycle of a business, and as such are classified as current liabilities, even where the credit period exceeds 12 months.

9 A B, C and D are all assets.

ANSWERS TO MODULE QUESTIONS

1 B Financial reporting is carried out by all businesses, no matter what their size or structure.

2 A Customers need to know that the business is making sufficient profits to be a secure source of supply.

3 Other examples of areas where the judgment of different people may vary are as follows:

(a) valuation of buildings in times of rising property prices

(b) research and development: is it right to treat this only as an expense? In a sense it is an investment to generate future revenue.

(c) accounting for inflation

(d) brands such as 'Coca Cola' or 'Hoover' – are they assets in the same way that a fork lift truck is an asset?

Working from the same data, different groups of people may produce very different financial statements. If the exercise of judgment is completely unrestrained, there will be no comparability between the accounts of different organisations. This will be all the more significant in cases where deliberate manipulation occurs, in order to present accounts in the most favourable light.

4 Methods of 'creative accounting' include:

- **'Off balance sheet financing'**: an entity enters into a financing transaction which is structured so that it can avoid having to recognise all its assets and liabilities in the statement of financial position. For example, a company might sell an asset but enter into an agreement to repurchase it after a set period of time. The substance of the transaction is that the company has a loan (a liability) secured on the asset that has been 'sold' but legally, the company has made a sale and so recognises cash and income. The company's financial performance and particularly its financial position appear to be much stronger than they are. Transactions such as these enable a company to 'hide' material borrowings from shareholders and other lenders.
- **'Window dressing'**: at the year-end an entity enters into transactions whose sole purpose is to improve the appearance of the financial statements. For example, a company might make a fictitious 'sale', which would be reversed by means of a credit note early in the new reporting period. Revenue and profit would appear to be higher than they really were.
- **'Profit smoothing'**: in a profitable year an entity deliberately recognises a liability for future expenditure to which it is not committed (for example, for a 'restructuring' or for future losses). This 'provision' is then available to be released to profit or loss to increase profits in a poor year (the provision is sometimes called the 'big bath').
- **'Aggressive earnings management'**: recognising sales revenue before it has been earned (before the entity has actually delivered the goods or performed the services).

Most of the accounting scandals of the past 20 years have involved one or more of these. For example, the management of Enron used a sophisticated form of off balance sheet financing to mislead the users of its financial statements.

5 The types of economic decisions for which financial statements are likely to be used include the following:

- decisions to buy, hold or sell equity investments;
- assessment of management stewardship and accountability;
- assessment of the entity's ability to pay employees;
- assessment of the security of amounts lent to the entity;
- determination of taxation policies;
- determination of distributable profits and dividends;
- inclusion in national income statistics; and/or
- regulations of the activities of entities.

6 The IASB *Conceptual Framework* recognises existing and potential investors, lenders and other creditors as the primary users of financial statements.

- **Investors** are the providers of risk capital:
  - Information is required to help make a decision about buying or selling shares, taking up a rights issue and voting.
  - Investors must have information about the level of dividend, past, present and future and any changes in share price.
  - Investors will also need to know whether the management has been running the company efficiently.
  - As well as the position indicated by the results (profit or loss) for the year, statement of financial position and earnings per share (EPS), investors will want to know about the liquidity position of the company, the company's future prospects, and how the company's shares compare with those of its competitors.
- **Lenders** need information to help them decide whether to lend to a company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate time and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.
- **Suppliers and other creditors** need to know whether the company will be a good customer and pay its debts.

Other potential users of financial information include:

- **Employees** need information about the security of employment and future prospects for jobs in the company, and to help with collective pay bargaining.
- **Customers** need to know whether the company will be able to continue producing and supplying goods.
- **Government's** interest in a company may be that of a creditor or customer, as well as being specifically concerned with compliance with tax and company law, ability to pay tax and the general contribution of the company to the economy.
- The **public** at large would wish to have information for all the reasons mentioned above, but it could be suggested that it would be impossible to provide general purpose accounting information which was specifically designed for the needs of the public.

7 (a) This is a change in presentation, so it does represent a change of accounting policy.

(b) This is a change of accounting estimate, not a change of accounting policy.

(c) This is a change of measurement basis, so it does represent a change of accounting policy.

8 STATEMENT OF PROFIT OR LOSS

	20X6 $'000	20X7 $'000
Sales	50 000	54 000
Cost of goods sold	(24 050)	(25 930)
Profit before tax	25 950	28 070
Income tax	(7 785)	(8 421)
Profit for the year	18 165	19 649

9 CHANGE IN ACCOUNTING ESTIMATE

The change in accounting estimate affects the accounts for 20X7 and subsequent years. At 31 December 20X7 the NBV of the asset is $60 000 (assuming that 20X7 depreciation has not yet been charged). This should be spread over the revised remaining useful life, that is, three years. Depreciation on the asset for 20X7, 20X8 and 20X9 will be $20 000 per annum.

10 STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	20X6	20X7
	$'000	$'000
Sales	47 400	67 200
Cost of goods sold (W1)	(38 770)	(51 600)
Profit before tax	8 630	15 600
Income tax (W2)	(2 589)	(4 680)
Profit for the year	6 041	10 920

RETAINED EARNINGS

	20X6	20X7
Opening retained earnings	$'000	$'000
As previously reported	13 000	21 981
Correction of prior period error (4200 – 1260)	–	(2 940)
As restated	13 000	19 041
Profit for the year	6 041	10 920
Closing retained earnings	19 041	29 961

Workings

1 Cost of goods sold

	20X6	20X7
	$'000	$'000
As stated in question	34 570	55 800
Inventory adjustment	4 200	(4 200)
	38 770	51 600

2 Income tax

	20X6	20X7
	$'000	$'000
As stated in question	3 849	3 420
Inventory adjustment (4200 × 30%)	(1 260)	1 260
	2 589	4 680

11 (a) This standard is a hybrid of the two. It contains a rule that research must be expensed and development costs are capitalised if all of the conditions are met. It then has a principle approach by requiring management to assess whether they meet the criteria.

(b) There is a danger that management might ignore the basic principle and simply apply the rules, particularly if this improved the entity's financial position. They might decide to capitalise all development costs rather than making the judgements required.

12 (a) If the business is to be closed down, the remaining three machines must be valued at the amount they will realise in a forced sale, that is, 3 × $60 = $180.

(b) If the business is viewed as a going concern, the inventory unsold at 31 December will be carried forward into the following year, when the cost of the three machines will be matched against the eventual sale proceeds in computing that year's profits. The three machines will therefore be valued at cost, 3 × $100 = $300.

13 (a) This is an intangible asset. There is a past event, control and future economic benefit as a result of cost savings.

(b) This cannot be classified as an asset. Baldwin Co. has no control over the car repair shop and it is difficult to argue that there are 'future economic benefits'.

(c) The bonus is a liability as the business has created an obligation.

14 The accounting policies apply the definitions and the recognition criteria in the *Conceptual Framework for Financial Reporting* (as well as the requirements of IAS 38 *Intangible Assets*).

Although expenditure on research activities may eventually result in future economic benefits (and therefore there may be an asset) it cannot be capitalised because it does not meet the recognition criteria: it is too early to say whether there will actually be any economic benefits or to be able to make any kind of reliable estimate of the amount.

In contrast, development expenditure is capitalised if it meets certain criteria. There is an asset: the new product and the ideas behind it are controlled by the entity and there is expected to be an inflow of economic benefits in the form of increased revenue or reduced costs. An intangible asset is recognised if the product or process is technically and commercially feasible and there are sufficient resources to complete development. If these criteria are met the inflow of economic benefits is **probable**. The second criteria of **reliable measurement** is also met because the amount to be capitalised is the cost of materials, labour and a proportion of overheads; these amounts will be recorded in the company's accounting system.

If development expenditure does not meet the criteria it is not recognised as an asset, but as an expense in the period in which it is incurred.

15 Because there is only a 40 per cent chance of the claim succeeding it is (a) not clear whether the company has a liability and (b) even if there is a liability it fails to meet the recognition criteria (it is only possible, **not probable**, that the entity will be found liable and that there will be an outflow of economic benefits in the form of damages paid).

This is a contingent liability (as defined by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*): a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of an uncertain future event not wholly within the control of the entity or a present obligation that is not recognised because it is not probable that an outflow of economic benefits will be required in settlement.

The company should not recognise a liability (a provision). Instead, it should disclose the possible liability in the notes to the financial statements.

16 The preference shares are a non-current liability and should not be presented as part of equity in the statement of financial position. They have the characteristics of a loan, rather than an owners' interest. A liability exists because the company has an obligation to pay interest over the life of the 'shares' and eventually to repay the principal amount.

17 In order for an entity to recognise revenue, there must be an increase in its net assets. Customers pay for airline tickets before they actually receive the service that they have paid for. The terms of airline tickets vary. In some cases the passenger can only fly on the date and to the destination originally booked, but in other cases tickets may be exchangeable, transferable or refundable or they may be valid for travel during a particular period, rather than on a specific flight.

The airline group does not recognise revenue until passengers actually travel, that is, when it actually delivers the service that has been paid for. Depending on the terms of the ticket, until that time the company probably has a liability in the form of an obligation to make a refund to the customer or to offer another flight. When the customer actually travels, the liability is discharged. The recognition conditions are met: there is a decrease in a liability, and a certain inflow of economic benefit which can be reliably measured.

Unused tickets can be recognised as revenue in certain conditions. For example, where a customer books a ticket that only permits travel on a specific flight and then fails to travel, the company still receives the cash paid for the ticket (an inflow of economic benefit that meets both recognition conditions) but has no obligation to provide another flight.

18 In the current period

The company has sunk a mine in the current period but has not yet commenced the extraction of minerals.

As a result of sinking the mine, at the year-end, the company has a legal obligation to restore the site at the end of the mine's operating life. It therefore has a liability which meets both the recognition criteria:

(a) the outflow of economic benefits is probable, even though it may not occur for many years; and

(b) the amount can be reliably estimated (on the basis of the amount it would cost to restore the site at the year-end, adjusted as necessary for expected future changes in technology etc).

The company should therefore recognise a liability in respect of 40 per cent of the total cost of restoring the site at the end of the mine's operating life. The remaining 60 per cent of the eventual cost of restoration is the result of extracting minerals. As this activity has not yet commenced, there is no related liability.

The restoration costs recognised as a liability also meet the definition of an asset (the expenditure will generate future economic benefits in the form of sales revenue) and also meet the recognition criteria: an inflow of economic benefit is probable and the cost of restoration can be reliably estimated. Therefore these costs form part of the cost of the mine within non-current assets.

In subsequent periods

The remaining 60 per cent of the eventual total cost of restoration relates to damage caused progressively as minerals are extracted. Therefore as this damage occurs over the mine's operating life, the liability for restoration costs is increased.

19 B A complete set of financial statements for a limited company (reporting entity) normally includes:

- a statement of the entity's financial position;
- a statement or statements showing the entity's financial performance;
- a statement showing changes in the entity's financial position (usually a statement of cash flows);
- a statement showing changes in equity; and
- notes to the financial statements and other supplementary information.

MODULE 2
THE ACCOUNTING THEORY

Learning objectives	Reference
Compare historical cost accounting with other methods of valuation and explain the differences	LO2.1
Explain agency and contracting theories and how they relate to accounting policy choice (positive accounting theory)	LO2.2
Apply the recognition criteria for the elements of the financial statements according to the conceptual framework (normative theory)	LO2.3

Topic list

1 Historical cost accounting
2 Measurement of the elements of financial statements
3 Positive and normative accounting theory
4 Alternatives to historical cost
5 Concepts of capital and capital maintenance
6 Current purchasing power (CPP)
7 Current cost accounting (CCA)
8 Agency theory
9 Information provided in annual reports
10 Information available to shareholders
11 Content of company reports

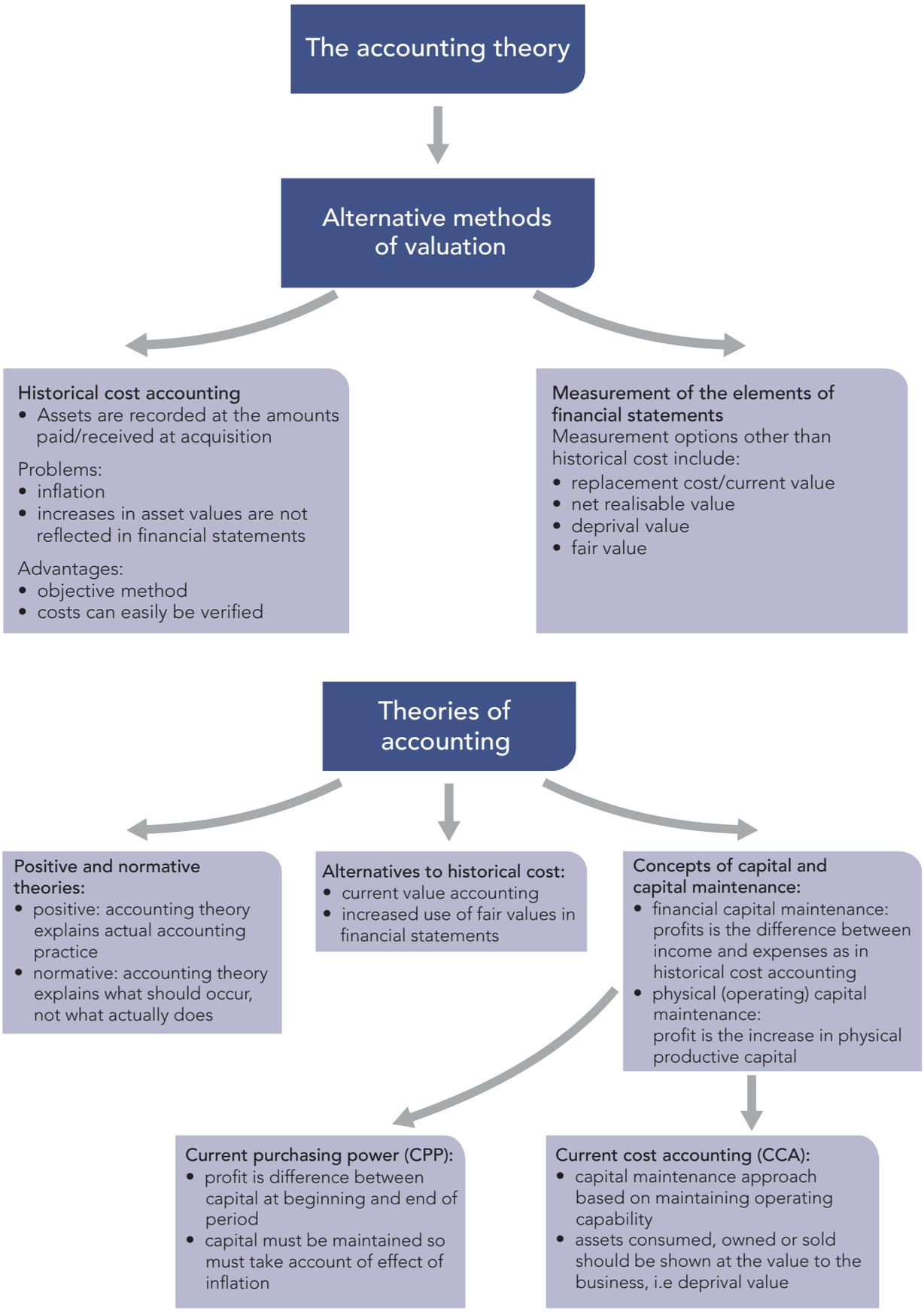
MODULE OUTLINE

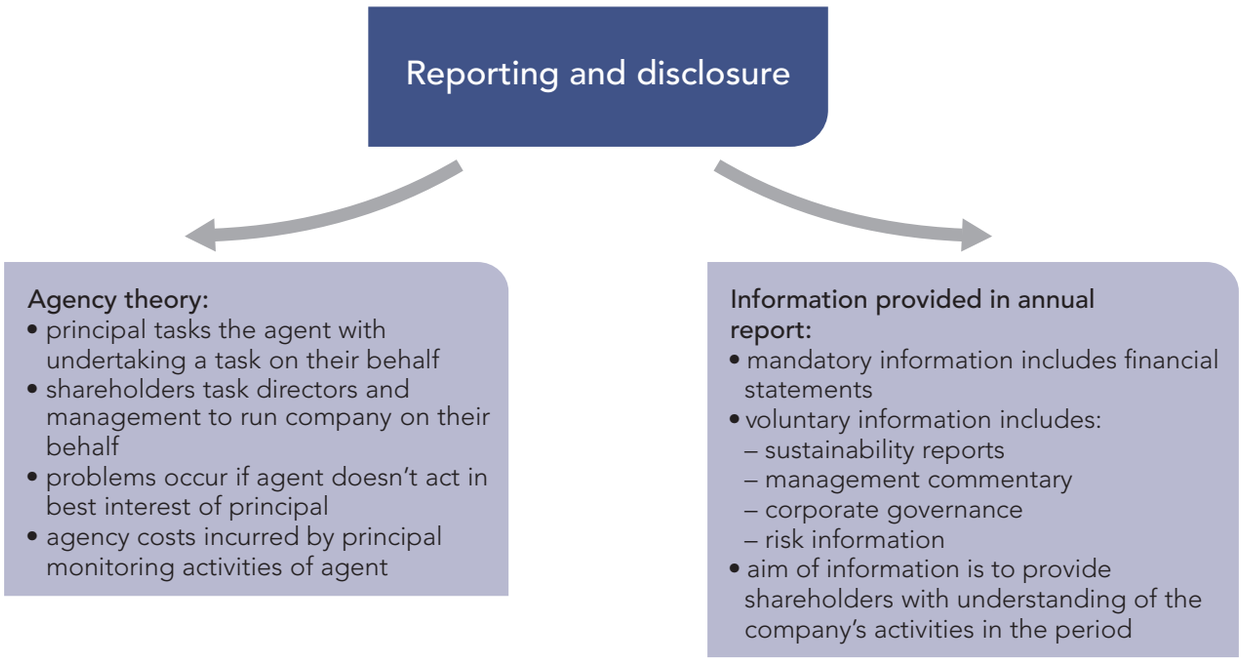
In this module we look at the advantages and disadvantages of using historic cost to measure assets and liabilities. Following on from that, we look at other measurement bases that can be used in financial statements including fair value, deprival value, replacement cost and net realisable value.

We then consider the alternatives to historical cost accounting. These are different ways of measuring profit that attempt to include the effect of price changes: current purchasing power accounting and current cost accounting.

We also examine agency theory and the elements of the relationship between shareholders and directors. We take this further by looking at the information disclosed in the annual report and financial statements that enables shareholders to assess the performance of the company. Some of this information is mandatory (it must be provided) and some is provided voluntarily.

The module content is summarised in the diagrams below.


The accounting theory
Alternative methods of valuation
Historical cost accounting
• Assets are recorded at the amounts paid/received at acquisition
Problems:
• inflation
• increases in asset values are not reflected in financial statements
Advantages:
• objective method
• costs can easily be verified
Measurement of the elements of financial statements
Measurement options other than historical cost include:
• replacement cost/current value
• net realisable value
• deprival value
• fair value
Theories of accounting
Positive and normative theories:
• positive: accounting theory explains actual accounting practice
• normative: accounting theory explains what should occur, not what actually does
Alternatives to historical cost:
• current value accounting
• increased use of fair values in financial statements
Concepts of capital and capital maintenance:
• financial capital maintenance: profits is the difference between income and expenses as in historical cost accounting
• physical (operating) capital maintenance:
profit is the increase in physical productive capital
Current purchasing power (CPP):
• profit is difference between capital at beginning and end of period
• capital must be maintained so must take account of effect of inflation
Current cost accounting (CCA):
• capital maintenance approach based on maintaining operating capability
• assets consumed, owned or sold should be shown at the value to the business, i.e deprival value



The accounting theory: Module summary diagrams

BEFORE YOU BEGIN

If you have studied these topics before, you may wonder whether you need to study this module in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the module to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the module you can find the information, and you will also find a commentary at the back of the Study Guide.

1 Explain the historical cost basis of measurement. (Section 1.1)

2 What are the problems of the historical cost basis of measurement? (Sections 1.2 and 2.6)

3 Which of the following are examples of deprival value?

I. fair value
II. historical cost
III. economic value
IV. replacement cost
V. net realisable value

A III and IV only
B III and V only
C I, II and III only
D III, IV and V only (Section 2.3)

4 What is the definition of fair value? (Section 2.4)

5 What is a normative accounting theory? (Section 3.3)

6 What is physical capital maintenance? (Section 5.1)

7 What is current purchasing power accounting? (Section 6)

8 What is current cost accounting? (Section 7)

9 What is an agency relationship? (Section 8.1)

10 What principal–agent relationships may exist in the context of a company? (Sections 8.3 and 8.7)

11 What is the purpose of corporate governance disclosures? (Section 9.2.1)

12 What are the advantages of disclosing non-mandatory information such as social reports? (Section 9.2.3)

13 What information does a corporate governance report contain? (Section 11.4)

14 What information does a corporate social responsibility report contain? (Section 11.5)

1 HISTORICAL COST ACCOUNTING

LO 2.1

Section overview

- A basic principle of accounting is that transactions are normally stated at their historical amount.
- Historical cost is the most commonly adopted measurement basis, but this is often combined with other bases, such as net realisable value or fair value.
- Although historical cost is objective, there are some problems associated with using it.

1.1 SUBJECT OUTLINE

Accounting concepts are part of the theoretical framework on which accounting practice is based. It is worth looking at one further general point: the problem of attributing **monetary values** to the items which appear in financial statements.

A basic principle of accounting (some writers include it in the list of fundamental accounting concepts) is that transactions are normally stated in accounts at their historical cost.

Measurement is defined below.

Definition

Measurement. The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income. *(Conceptual Framework)*

This involves the selection of a particular **basis of measurement**. A number of these are used to different degrees and in varying combinations in financial statements. The *Conceptual Framework* provides the following definitions:

Definitions

Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the **fair value** of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present value. A current estimate of the present discounted value of the future net cash flows in the normal course of business. *(Conceptual Framework)*

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, for example, inventory is carried at the lower of cost and net realisable value, marketable securities and non-current assets may be carried at market value (or fair value) and pension liabilities are carried at their present value.

During the 1970s and 1980s some entities used current cost as a way of dealing with the effects of high rates of inflation. However, at the present time current cost is used very rarely.

1.2 HISTORICAL COST

Definition

The historical cost convention has a number of implications:

- Transactions are recorded at original cost. This means, for example, that the cost of goods sold is not suddenly increased at the end of the year.
- Assets are stated at their historical cost. In other words, the value of an asset in a statement of financial position is based on the price that was paid for it.

An important **advantage** of this convention is that there is usually **objective**, documentary evidence to prove the purchase price of an asset, or amounts paid as expenses.

In general, accountants prefer to deal with objective costs, rather than with estimated values. This is because valuations tend to be subjective and to vary according to the purpose of the valuation. There are some **problems** with the principle of historical cost which include:

- the wearing out of assets over time;
- the increase in market value of property; and
- inflation.

You may be able to think of other problems.

Worked Example: Problems with historical cost

Suppose that a partnership buys a machine to use in its business. The machine has an expected useful life of four years. At the end of two years the partnership is preparing a statement of financial position and has to decide what monetary amount to attribute to the asset. Numerous possibilities might be considered:

- the original cost (historical cost) of the machine;
- half of the historical cost, on the basis that half of its useful life has expired;
- the amount the machine might fetch on the second-hand market;
- the amount it would cost to replace the machine with an identical machine;
- the amount it would cost to replace the machine with a more modern machine incorporating the technological advances of the previous two years; and/or
- the machine's economic value, that is, the amount of the profits it is expected to generate for the partnership during its remaining life.

All of these valuations have something to recommend them, but the great advantage of the first two is that they are based on a figure (the machine's historical cost) which is **objectively verifiable**.

2 MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENTS

LO 2.1

Section overview

- Besides historical cost, there are a variety of other possible methods of measurement:
  - fair value
  - deprival value
  - replacement cost
  - net realisable value
- The main advantage of historical cost accounting is that the cost of an item is known and can be proved. There are also a number of disadvantages and these usually arise in times of rising prices (inflation). Other disadvantages have arisen as business practice and transactions have become more complex.

2.1 REPLACEMENT COST

Definition

Replacement cost means the amount needed to replace an item with an identical item. This is the same as current cost.

Worked Example: Replacement cost

XY Co. purchased a machine five years ago for $15 000. It is now worn out and needs replacing. An identical machine can be purchased for $20 000.

Historical cost is $15 000

Replacement cost is $20 000

2.2 NET REALISABLE VALUE

Definition

Net realisable value is the expected price less any costs still to be incurred in getting the item ready for sale and then selling it.

Worked Example: Net realisable value

XY Co.'s machine from the example above can be restored to working order at a cost of $5000. It can then be sold for $10 000. What is its net realisable value?

Net realisable value = $10 000 – $5000
= $5000

2.3 DEPRIVAL VALUE

Definition

Deprival value is the loss which a business entity would suffer if it were deprived of the use of the asset.

Value to the business, or deprival value, can be any of the following values:

- **Replacement cost**: in the case of non-current assets, it is assumed that the replacement cost of an asset would be its net replacement cost (NRC), its gross replacement cost minus an appropriate provision for depreciation to reflect the amount of its life already 'used up'.
- **Net realisable value** (NRV): what the asset could be sold for, net of any disposal costs.
- **Economic value** (EV), or value in use: what the existing asset will be worth to the company over the rest of its useful life that is, the present value of cash flows expected to be generated by the asset in the future.

The deprival value is the lower of replacement cost and recoverable amount. In turn the recoverable amount is the higher of net realisable value and economic value.

Deprival value, or value to the business, is supposed to reflect economic reality or management's intentions. Where there is a choice between selling an asset and continuing to use it, it is assumed that the business will always take the course of action that will maximise the resulting inflow of economic benefit.

Worked Example: Economic value

Suppose XY Co. purchases a new machine for $20 000. It is estimated that the new machine will generate profits of $4000 per year for its useful life of 8 years. What is its economic value?

Economic value = $4000 × 8
= $32 000

Note that these cash flows should be discounted, but discounting is beyond the coverage of this unit. The topic of deprival value will be covered in more detail later in this module.

Question 1: Deprival value

On 1 January 20X1 a company bought plant costing $50 000. Its useful life was estimated to be 10 years and it had no residual value.

At 31 December 20X3 it was estimated that the plant could be sold for $20 000 but it would have to be dismantled, which would cost approximately $2000.

If the company continues to use the machine, management estimates that it will generate net cash inflows with a present (discounted) value of $25 000.

New plant of the same type would cost $60 000 at 31 December 20X3.

Required

Calculate the deprival value of the asset. Explain why this amount is its value to the business.

(The answer is at the end of the module.)

2.4 FAIR VALUE

Definition

Fair value is 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

Fair value is the amount an asset could be sold or a liability discharged in an arm's length transaction. Fair value is the market value of an item in a hypothetical transaction. In IFRS it is normally taken to be open market value, or 'exit value', from the seller's perspective.

Fair value can be more reliably estimated where there is an active market for the asset being valued. But where there is no active market, substitutes or estimates have to be used which, in some cases, may result in a valuation that does not fairly represent the resource available.

Question 2: Deprival value and fair value

A company has two properties.

I. a specialised property: a school building

II. an office building that it is holding for its investment potential, rather than for its use in the business

For which of these properties is deprival value likely to be approximately the same as fair value?

A I only

B II only

C both I and II

D neither I nor II

(The answer is at the end of the module.)

2.5 ADVANTAGES OF HISTORICAL COST ACCOUNTING

Historical cost accounting has several important advantages.

- It is **objective**. Cost is known and can be proved (e.g. by the invoice). If fair values or other forms of current value are used, these are necessarily subjective.
- It is **easily understood** by users. Profit is the amount by which selling price exceeds the (depreciated) original cost of the item sold or service provided.
- It is **easy to apply**. In contrast, most of the alternatives (deprival value, current cost and even fair value) can be difficult and time consuming to estimate or calculate. For example, arriving at deprival value may involve estimating future cash flows for a number of years and then discounting them to present value.
- It **provides useful information** to users. Users need reliable and faithfully represented information about past transactions in order to predict an entity's future performance. Information about the current or fair value of assets may be useful to large institutional investors in listed companies, but is largely irrelevant for others.
- It is **prudent**. Until fairly recently, prudence (conservatism) was recognised as a fundamental accounting concept. Revenue and profits are not anticipated, but included in profit or loss only when it is reasonably certain that they will be realised in the form of cash or other assets. Where there is uncertainty, measuring non-current assets at historical cost is a cautious approach.
- It has **stood the test of time**. Some theorists argue that historical cost is worth retaining because it has been developed by trial and error by business owners and managers over several years. In contrast, systems of current cost accounting and fair value accounting are based on academic theories and have never really been proved to work in practice.
- If (for example) the current market prices of property or investments are very different from their historical cost, this information **can be disclosed** in the notes to the financial statements. There is no need to adjust the amounts in the statement of financial position or the other primary statements.

Defenders of historical cost accounting argue that, although historical cost has shortcomings, there is no real evidence that current costs or fair values provide more useful information. Some advantages of historical cost accounting follow from the disadvantages of current value or fair value accounting:

- Use of fair values and current values **can encourage management to manipulate the amounts** in the financial statements, because current value can only be an estimate. Accounting standards and other forms of regulation can provide some protection against this, by, for example, requiring regular revaluations by qualified external valuers, but there will always be some scope for 'creative accounting'.

- Current value accounting **anticipates profits that may never be realised**. Market prices may fall or the asset may be damaged before it can be sold. Alternatively, the entity may have no intention of selling the asset in the foreseeable future (for example, because it uses it in its operations).
- Because market values can fluctuate, using fair value can **cause volatility** in the financial statements. IFRS require gains and losses on revaluation of investment property and some financial instruments to be recognised directly in profit or loss. When reported results fluctuate unexpectedly it can be difficult for users to make a fair assessment of an entity's performance and to understand underlying trends. Some believe this volatility is acceptable because it reflects economic reality. However, unexpected losses can also have serious economic consequences; many believe that the use of fair values contributed to the global economic crisis in 2008.

Question 3: Objectivity

The main arguments in favour of historical cost accounting are that it is objective and that users generally find it easier to understand than the alternatives, such as fair value.

Required

Briefly explain why this may not always be the case.

(The answer is at the end of the module.)

2.6 DISADVANTAGES OF HISTORICAL COST ACCOUNTING

There are a number of **disadvantages** of historical cost accounting**.** Many of these arise in particular in times of rising prices (inflation). When inflation is low, historical cost accounting is usually satisfactory. However, when inflation is high the following problems can occur. Other disadvantages have arisen as business practice and transactions have become more complex.

2.6.1 NON-CURRENT ASSET VALUES ARE UNREALISTIC

The most striking example is property. Although some entities have periodically updated the amounts shown in the statement of financial position, in general there has been a lack of consistency in the approach adopted and a lack of clarity in the way in which the effects of these changes in value have been expressed.

If non-current assets are measured at their historical cost, **unrealised holding gains are not recognised**. This means that the total holding gain, if any, will be recognised during the year in which the asset is realised, rather than spread over the period during which it was owned. In contrast unrealised holding losses are recognised in the form of impairment of assets.

There are, in essence, two contradictory points to be considered:

1. Although it has long been accepted that a statement of financial position prepared under the historical cost concept is an historical record and not a statement of current worth, many people now argue that the statement of financial position should at least give an indication of the **current value** of the company's tangible net assets.
2. Traditionally, generally accepted accounting practice has required that profits should only be recognised when realised in the form of either cash or other assets, the ultimate cash realisation of which can be assessed with reasonable certainty (**prudence or conservatism**). It may be argued that recognising unrealised holding gains on non-current assets is contrary to this convention.

On balance, the weight of opinion held generally by the IASB and specifically by Australia and the UK is now in favour of restating asset values. It is felt that the criticism based on prudence can be met by ensuring that valuations are made as objectively as possible (e.g. in the case of property, by having independent expert valuations), by not taking unrealised gains through profit or loss, but instead through reserves and by disclosing assumptions on which fair value estimate is based.

2.6.2 DEPRECIATION IS INADEQUATE TO FINANCE THE REPLACEMENT OF NON-CURRENT ASSETS

Depreciation is not provided for in order to enforce retention of profits and therefore ensure that funds are available for asset replacement. It is intended as a measure of the contribution of non-current assets to an entity's activities in the period. However, an incidental effect of providing for depreciation is that not all liquid funds can be paid out to investors thus enabling funds for asset replacement to remain on hand. What is important is not the replacement of one asset by an identical new one (something that rarely happens) but the replacement of the **operating capability** represented by the old asset.

2.6.3 HOLDING GAINS ON INVENTORIES ARE INCLUDED IN PROFIT

Another criticism of historical cost accounting is that it does not fully reflect the value of the asset consumed during the accounting year.

During a period of high inflation the monetary value of inventories held may increase significantly while they are being processed. The conventions of historical cost accounting lead to the unrealised part of this holding gain (known as **inventory appreciation**) being included in profit for the year.

The following simple example is given to help your understanding of this difficult concept.

Worked Example: Holding gain

At the beginning of the year a company has 100 units of inventory and no other assets. Its trading account for the year is shown below.

TRADING ACCOUNT

	Units	$		Units	$
Opening inventory	100	200	Sales (made 31 December)	100	500
Purchases (made 31 December)	100	400			
	200	600			
Closing inventory (FIFO basis)	100	400			
	100	200 (COGS)			
Gross profit	–	300			
	100	500 (Sales)		100	500

Apparently the company has made a gross profit of $300. But, at the beginning of the year the company owned 100 units of inventory and at the end of the year it owned 100 units of inventory and $100 cash (sales $500 less purchases $400). From this it would seem that a profit of $100 is more reasonable. The remaining $200 is inventory appreciation arising because the purchase price increased from $2 to $4.

The criticism can be overcome by using a **capital maintenance concept** based on physical units rather than money values (explained in more detail later in this module).

2.6.4 PROFITS (OR LOSSES) ON HOLDINGS OF NET MONETARY ITEMS ARE NOT SHOWN

In periods of inflation the purchasing power, and therefore the value, of money falls. It follows that an investment in money will have a lower real value at the end of a period of time than it did at the beginning. A loss has been incurred. Similarly, the real value of a monetary liability will reduce over a period of time and a gain will be made.

2.6.5 THE TRUE EFFECT OF INFLATION ON CAPITAL MAINTENANCE IS NOT SHOWN

To a large extent this follows from the points already mentioned. It is a widely held principle that distributable profits should only be recognised after full allowance has been made for any erosion in the capital value of a business. In historical cost accounts, although capital is maintained in **nominal money terms**, it may not be in **real terms**. So, profits may be distributed to the detriment of the long-term viability of the business. This criticism may be made by those who advocate capital maintenance in physical terms.

2.6.6 COMPARISONS OVER TIME ARE UNREALISTIC

This will tend to an exaggeration of growth. For example, if a company's profit in 1982 was $100 000 and in 2012 $500 000, a shareholder's initial reaction might be that the company had done rather well. If, however, it was then revealed that with $100 000 in 1982 they could buy exactly the same goods as with $500 000 in 2012, the apparent growth would seem less impressive.

2.6.7 HISTORICAL COST NO LONGER REFLECTS ECONOMIC REALITY

The arguments against historical cost accounting set out above mainly relate to its conceptual shortcomings. More recently criticisms of historical cost have focused on its failure to capture important information about particular types of transaction or event. There are two main issues:

1. Historical cost **does not record any transaction that does not have a monetary impact.** This is particularly important where an entity holds certain types of financial instruments, such as **derivatives**. A derivative is a financial instrument whose value changes in response to the change in a specified interest rate, commodity price, foreign exchange rate or other variable. Derivatives can be acquired for very little or no upfront cost, but can expose an entity to very significant **uncertainty and risk** (potential for gain or loss) and this can have a very material effect on its financial performance, financial position and cash flows. During the 1990s there were a number of high profile accounting scandals and company failures involving derivatives. Because a derivative contract normally has little or no initial cost, under traditional accounting it **may not be recognised in the financial statements** at all. Alternatively it may be recognised at an amount which bears no relation to its current value. This is clearly misleading and leaves users of the financial statements **unaware of the level of risk** that the company faces. Current standards require derivatives to be measured at fair value.
2. Historical cost provided relevant information when the main purpose of financial statements was to enable owners to assess the stewardship of management. The emphasis is now on the financial statements as a means of providing information to investors, lenders and other creditors and their advisors to **help them to make buy, hold or sell decisions**. Many believe that **fair value provides** these users with **more relevant information** than historical cost because:
   - fair values have more **predictive value**;
   - some assets are **traded on an active market** or held for their **investment potential** (rather than being held to be used in the business);
   - fair value often reflects **the way risks are managed** (for financial instruments); and
   - for assets such as property, fair value provides information on the **resources actually available** to an entity.

   The *Conceptual Framework* explains that users need information to help them assess the **prospects for future net cash inflows** to an entity; this is unlikely to be provided by historical cost information alone.

The points mentioned above have demonstrated some of the accounting problems associated with historical cost accounting, particularly in times of severe and prolonged inflation. So far, we have considered possible alternative measurement bases, such as fair value, but there are also alternative **systems** of accounting.

Of the various possible systems of accounting for price changes, most fall into one of three categories as follows:

1. general price change bases and in particular, **current purchasing power** (CPP)
2. **current value bases**. The basic principles of all these are:
   (a) to show statement of financial position items at some form of current value rather than historical cost; and
   (b) to compute profits by matching the current value of costs at the date of consumption against revenue.

   The current value of an item will normally be based on replacement cost, net realisable value or economic value.

3. a **combination** of these two systems: suggestions of this type have been put forward by many writers

in practice, however, these methods are rarely applied.

2.7 WHY MODIFIED HISTORICAL COST ACCOUNTING IS STILL USED

Modified historical cost accounting refers to the method of accounting whereby assets and liabilities are measured at historical cost with the exception of certain assets which may be revalued to current values (fair value). This is the type of accounting prescribed by IFRS. Despite criticism, modified historical cost accounting is still widely used. There are various reasons for this, not the least of which is **resistance to change** in the conservative accounting profession.

Many entities prepare **modified historical cost accounts**: some assets (normally non-current tangible assets and financial instruments) are measured at fair value or current value/deprival value while the remainder continue to be measured at historical cost. Modified historical cost accounts are **easy** to prepare, and easier to read and understand than the alternatives. While such accounts do not reflect current values, the revaluation of non-current assets greatly improves the usefulness of them. IFRS encourages the use of fair value, although entities can choose to measure non-financial assets, including investment property, at depreciated historical cost.

In addition, as we have seen, alternatives such as fair value and deprival value also have disadvantages. Some argue that no single alternative measurement base can fairly represent the economic substance of all transactions.

3 POSITIVE AND NORMATIVE ACCOUNTING THEORY

LOs 2.2, 2.3

Section overview

- Positive accounting theory explains and attempts to predict actual accounting practice.
- Normative accounting theory describes what **should** occur rather than predicting what actually does occur.

3.1 ACCOUNTING THEORY

An accounting theory refers to having a body of knowledge which sets out the rules and regulations to be followed in accounting for transactions. Accounting theories should provide guidance to accounting practice and a basis for the future development of accounting standards.

There is no single theory of accounting, several have developed over the years. Theory usually underpins the development of standards. It can be argued that the IASB's *Conceptual Framework* is an attempt at creating a body of accounting theory as it sets out the principles and process of accounting for items in the financial statements.

In this section there are two theories we will briefly look at, positive accounting theory and normative accounting theory.

3.2 POSITIVE ACCOUNTING THEORY

A positive approach to accounting is one where accounting theory is thought of as a body of knowledge that explains and attempts to **predict** actual accounting practice. Positive theory does not attempt to prescribe what businesses should or ought do, it merely predicts behaviour. It originated as a theory from the work of two academics, Watts and Zimmerman in the 1970s and 1980s. Therefore, information that provides guidance on accounting for particular events would be based on what has been observed as actual accounting practice rather than what should occur. It is an explanation of what actually happens rather than what should happen. Supporters of positive accounting theory can

attempt to predict accounting behaviour by observing what actually happens and applying this to particular situations.

One example of a positive accounting theory is the Efficient Market Hypothesis (or EMH). This is a theory which attempts to explain the way in which share prices move in response to new information, and it is in this theory that positive accounting theory found its roots.

3.3 NORMATIVE ACCOUNTING THEORY

Normative accounting theory differs from positive theory in that it describes what **should** occur rather than predicting what actually does occur. This theory suggests that accounting should specify how items should be defined and recognised. Normative theory may not be based on actual accounting practice as its basis is not what actually happens but what should happen. For example, the use of a conceptual framework and accounting standards based on that framework would be an example of normative theory.

In this module we will be looking at the two main systems that have been developed as possible alternatives to historical cost accounting: current cost accounting (CCA) and current purchasing power (CPP). These are also normative theories of accounting.

4 ALTERNATIVES TO HISTORICAL COST

Section overview

- A number of alternatives to historical cost accounting have been developed and discussed. It is unlikely that the IASB will propose a full system of current cost accounting in the near future, but standards are requiring increasing use of fair values.

4.1 CURRENT VALUE ACCOUNTING

The move towards current value accounting has already taken a number of steps. Entities are now permitted to revalue non-current assets such as land and buildings in line with fair value, and certain financial assets and liabilities such as securities and investments can be carried at **fair value**, defined in several IFRS 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'.

These developments, and the use of fair values in acquisition accounting (to measure the assets of the subsidiary and therefore arrive at a realistic goodwill valuation) are relatively uncontroversial. However, there are those who would like fair value to be used more widely as a system of current value. Under Current Value Accounting (CVA) the original cost of an asset would be replaced with its discounted present value, that is, the present value of its future cash flows. This is obviously suitable for monetary items such as receivables and payables. The expected inflows and outflows would be discounted to present value using an interest rate which reflects the current time value of money. For assets such as vehicles, which do not yield a pre-determined future cash flow, current cost would be a more applicable measure – based either on the current cost of the original asset or on its replacement by a more up to date version. For inventories, current replacement cost or net realisable value would be indicated.

4.2 HISTORICAL COST ACCOUNTING – DOES IT HAVE A FUTURE?

Investment analysts have argued that historical cost information is out of date and not relevant and that fair value information, based on active market prices, is the best available measure of future cash flows which an asset can be expected to generate.

This argument is heard increasingly in the US, where investors are the most highly-regarded user group for financial information.

We will now go on to discuss two alternative systems which have sought in the past to address the shortcomings of historical cost accounting – **current purchasing power (CPP)** and **current cost accounting (CCA)**. We begin by looking at the fundamental difference between these two systems being a different concept of capital maintenance and therefore of profit.

5 CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

LO 2.1

Section overview

- An entity should select the concept of capital that is appropriate to the needs of the users of its financial statements.

Most entities use a **financial concept of capital** when preparing their financial statements.

5.1 CONCEPTS OF CAPITAL MAINTENANCE AND THE DETERMINATION OF PROFIT

First of all, we need to define the different concepts of capital.

Definitions

Under a financial concept of capital, such as invested money or invested purchasing power, capital is the net assets or equity of the entity. The financial concept of capital is adopted by most entities. Focusing on the equity ownership of the entity is often referred to as the **proprietary concept of capital**: if we pay all profits out as dividends and inflation exists then in future our business will gradually run down, as our cash will become insufficient to buy replacement inventory.

Under an operating concept of capital **(also known as physical concept of capital)**, such as operating capability, capital is the productive capacity of the entity based on, for example, units of output per day. Capital is looked at as the capacity to maintain a level of assets, by using **replacement cost** for our cost of sales we will set aside enough cash to buy replacement assets.

The definition of profit is also important.

Definition

Profit. The residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. Any amount over and above that required to maintain the capital at the beginning of the period is profit. *(Conceptual Framework)*

The main difference between the two concepts of capital maintenance is the treatment of the **effects of changes in the prices of assets and liabilities** of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

(a) **Financial capital maintenance**: profit is the increase in nominal money capital over the period. This is the concept used under historical cost accounting.

(b) **Operating (or Physical) capital maintenance**: profit is the increase in the physical productive capacity over the period. This is the concept used in CCA.

6 CURRENT PURCHASING POWER (CPP)

LO 2.1

Section overview

- Current purchasing power accounting (CPP) measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

6.1 CAPITAL MAINTENANCE

Profit can be measured as the **difference between how wealthy a company is at the beginning and at the end of an accounting period**.

- This wealth can be expressed in terms of the capital of a company as shown in its opening and closing statements of financial position.
- A business which maintains its capital unchanged during an accounting period can be said to have broken even.
- Once **capital has been maintained**, **anything** achieved **in excess represents profit**.

For this analysis to be of any use, we must be able to draw up a company's statement of financial position at the beginning and at the end of a period, so as to place a value on the opening and closing capital. There are particular difficulties in doing this during a **period of rising prices**.

In conventional historical cost accounts, assets are stated in the statement of financial position at the amount it cost to acquire them (less any amounts written off in respect of depreciation or impairment in value). Capital is simply the **difference between assets and liabilities**.

For example, consider the following opening and closing statements of financial position of a company.

	Opening $	Closing $
Inventory (100 items at cost)	500	600
Other net assets	1 000	1 000
Capital	1 500	1 600

Assuming that no new capital has been introduced during the year, and no capital has been distributed as dividends, the profit shown in historical cost accounts would be $100, being the excess of closing capital over opening capital. And yet in physical terms the company is no better off: it still has 100 units of inventory (which cost $5 each at the beginning of the period, but $6 each at the end) and its other net assets are identical. The 'profit' earned has merely enabled the company to keep pace with inflation.

An alternative to the concept of capital maintenance based on historical costs is to express capital in **physical** terms. On this basis, no profit would be recognised in the example above because the physical substance of the company is unchanged over the accounting period. Capital is maintained if at the end of the period the company is in a position to achieve the same physical output as it was at the beginning of the period. You should bear in mind that financial definitions of capital maintenance are not the only ones possible; in theory at least, there is no reason why profit should not be measured as the increase in a company's **physical** capital over an accounting period.

6.2 THE UNIT OF MEASUREMENT

Another way to tackle the problems of capital maintenance in times of rising prices is to look at the **unit of measurement** in which accounting values are expressed.

It is a basis of conventional accounting, as it has developed over the years, that value should be measured in terms of money. It is also **implicitly assumed** that **money values are stable**, so that $1 at the start of the financial year has the same value as $1 at the end of that year. But when **prices are**

rising, this assumption is invalid: **$1 at the end of the year has less value (less purchasing power) than it had one year previously**.

This leads to problems when aggregating amounts which have arisen at different times. For example, a company's non-current assets may include items bought at different times over a period of many years. They will each have been recorded in $, but the value of $1 will have varied over the period. In effect, the **non-current asset figure in a historical cost statement of financial position is an aggregate of a number of items expressed in different units**. It could be argued that such a figure is **meaningless**.

One possibility would be to re-state all accounts items in terms of a stable monetary unit. There would be difficulties in practice, but in theory there is no reason why a stable unit ($ CPP = $ of current purchasing power) should not be devised. In this section we will look at a system of accounting (current purchasing power accounting, or CPP) based on this idea.

6.3 SPECIFIC AND GENERAL PRICE CHANGES

We can identify two different types of price inflation.

When prices are rising, it is likely that the **current value of assets will also rise**, but not necessarily by the general rate of inflation. For example, if the replacement cost of a machine on 1 January 20X2 was $5000, and the general rate of inflation in 20X2 was 8 per cent, we would not necessarily expect the replacement cost of the machine at 31 December 20X2 to be $5000 plus 8% = $5400. The rate of price increase on the machinery might have been less than 8 per cent or more than 8 per cent. (Conceivably, in spite of general inflation, the replacement cost of the machinery might have gone down.)

- **Specific price inflation**, which measures price changes over time for a specific asset or group of assets.
- **General price inflation**, which is the average rate of inflation, which reduces the general purchasing power of money.

To counter the problems of specific price inflation some system of current value accounting may be used (such as current cost accounting). The capital maintenance concepts underlying current value systems do not attempt to allow for the maintenance of real value in money terms.

Current purchasing power (CPP) accounting is based on a different concept of capital maintenance.

Definition

CPP measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

When applied to historical cost accounting, CPP is a system of accounting which makes **adjustments to income and capital values to allow for the general rate of price inflation.**

6.4 MONETARY AND NON-MONETARY ITEMS

It is obvious that during a period of inflation borrowers benefit at the expense of lenders. A sum borrowed at the beginning of the year will cost less to repay at the end of the year (although lenders will seek to allow for this in higher interest charges). Similarly, customers with balances owing benefit at the expense of suppliers. CPP accounting seeks to remove this gain arising through changes in the value of money, or 'holding gain'.

Monetary items (cash, receivables, payables) cannot be restated as their amount is fixed.
Non-monetary items (non-current assets and inventories) are restated in line with the general price index (at $c) and the balancing figure is equity.

Question 4: CPP profits

Rice and Price Co. set up in business on 1 January 20X5 with no non-current assets, and cash of $5000. On 1 January they acquired inventories for the full $5000, which they sold on 30 June 20X5 for $6000. On 30 November they obtained a further $2100 of inventory on credit. The index of the general price level gives the following index figures:

Date	Index
1 January 20X5	300
30 June 20X5	330
30 November 20X5	350
31 December 20X5	360

Required

Calculate the CPP profits (or losses) of Rice and Price for the year to 31 December 20X5.

(The answer is at the end of the module.)

6.5 THE ADVANTAGES AND DISADVANTAGES OF CPP ACCOUNTING

6.5.1 ADVANTAGES

- The restatement of asset values in terms of a **stable money value** provides **a more meaningful basis of comparison** with other companies. Similarly, provided that previous years' profits are re-valued into CPP terms, it is also possible to compare the current year's results with past performance.
- **Profit** is measured in **'real' terms** and excludes 'inflationary value increments'. This enables better forecasts of future prospects to be made.
- CPP **avoids the subjective valuations** of current value accounting, because a single price index is applied to all non-monetary assets.
- CPP **provides a stable monetary** unit with which to value profit and capital.
- Since it is based on historical cost accounting, **raw data is easily verified**, and measurements of value can be readily audited.

6.5.2 DISADVANTAGES

- 'Generalised purchasing power' as measured by a retail price index, or indeed any other general price index, has no obvious practical significance.

  'Generalised purchasing power has no relevance to any person or entity because no such thing exists in reality, except as a statistician's computation.'(T A Lee)
- The use of indices inevitably involves **approximations** in the measurements of value.
- The value **of assets in a CPP statement of financial position has less meaning than a current value statement of financial position**. It cannot be supposed that the CPP value of net assets reflects:
  - the general goods and services that could be bought if the assets were released; and
  - the consumption of general goods and services that would have to be forgone to replace those assets.

  In this respect, a CPP statement of financial position has similar drawbacks to an historical cost statement of financial position (i.e. it is fairly meaningless).

7 CURRENT COST ACCOUNTING (CCA)

LO 2.1

Section overview

- Current cost accounting (CCA) reflects an approach to capital maintenance based on maintaining the operating capability of a business. Assets consumed or sold, and assets in the statement of financial position, are measured at their value to the business.

7.1 VALUE TO THE BUSINESS (DEPRIVAL VALUE)

Current cost accounting (CCA) reflects an approach to capital maintenance based on maintaining the **operating capability** of a business. The conceptual basis of CCA is that the value of assets consumed or sold, and the value of assets in the statement of financial position, should be stated at their **value to the business** (also known as 'deprival value'). (See Section 2.3.)

(a) A basic assumption in CCA is that 'capital maintenance' should mean maintenance of the 'business substance' or 'operating capability' of the business entity. As we have seen already, it is generally accepted that profit is earned only after a sufficient amount has been charged against sales to ensure that the capital of the business is maintained. In CCA, a **physical** rather than financial definition of capital is used: capital maintenance is measured by the ability of the business entity to keep up the same level of operating capability.

(b) 'Value to the business' is the required method of valuation in CCA, because it reflects the extra funds which would be required to maintain the operating capability of the business entity if it suddenly lost the use of an asset.

The deprival value is the lower of replacement cost and recoverable amount. In turn the recoverable amount is the higher of net realisable value and economic value.

If the asset is worth replacing, its deprival value will always be net replacement cost. If the asset is not worth replacing, it might have been disposed of straight away, or else it might have been kept in operation until the end of its useful life.

We have already seen that if an asset is not worth replacing, the deprival value will be NRV or EV. However, there are many assets which will not be replaced either:

- because the asset is **technologically obsolete**, and has been (or will be) superseded by more modern equipment; or
- because the business is **changing the nature of its operations** and will not want to continue in the same line of business once the asset has been used up.

Such assets, even though there are reasons not to replace them, would still be valued (usually) at net replacement cost, because this 'deprival value' still provides an estimate of the **operating capability** of the business.

7.2 CCA PROFITS AND DEPRIVAL VALUE

The deprival value of assets is reflected in the CCA statement of profit or loss by the following means:

- **Depreciation** is charged on non-current assets on the basis of **gross replacement cost** of the asset (where NRC is the deprival value).
- Where **NRV or EV** is the deprival value, the charge against CCA profits will be the **loss in value of the asset** during the accounting period; that is, from its previous carrying value to its current NRV or EV.
- **Goods sold** are charged at their **replacement cost**. Therefore if an item of inventory cost $15 to produce, and sells for $20, by which time its replacement cost has risen to $17, the CCA profit would be $3.

	$
Sales	20
Less replacement cost of goods sold	17
Current cost profit	3

7.3 CCA VERSUS ACCOUNTING FOR INFLATION

Worked Example: CCA versus accounting for inflation

Suppose that Arthur Smith Co. buys a non current asset on 1 January for $10 000. The estimated life of the asset is five years, and straight line depreciation is charged. At 31 December the gross replacement cost of the asset is $10 500 (5 per cent higher than on 1 January) but general inflation during the year, as measured by the retail price index, has risen 20 per cent.

(a) To maintain the value of the business against inflation, the asset should be revalued as follows:

	$
Gross replacement cost ($10 000 × 120%)	12 000
Depreciation charge for the year (× 20%)	2 400
Net value in the statement of financial position	9 600

(b) In CCA, the business maintains its operating capability if we revalue the asset as follows:

	$
Gross replacement cost	10 500
Depreciation charge for the year (note)	2 100
NRC value in the statement of financial position	8 400

Note:	$
Historical cost depreciation	2 000
CCA depreciation adjustment (5%)	100
Total CCA depreciation cost	2 100

CCA preserves the operating capability of the company but does not necessarily preserve it against the declining value in the purchasing power of money (against inflation). As mentioned previously, CCA is a system which takes account of specific price inflation (changes in the prices of specific assets or groups of assets) but not of general price inflation.

A strict view of current cost accounting might suggest that a set of CCA accounts should be prepared from the outset on the basis of deprival values. In practice, current cost accounts are usually prepared by starting from historical cost accounts and making appropriate adjustments.

7.4 CCA ACCOUNTS

CCA accounts will include the following adjustments:

1. Depreciation adjustment – to amend depreciation in line with the gross replacement cost of the asset.
2. Cost of sales adjustment – to take account of increases in inventory prices and remove any element of profit based on this.
3. Working capital adjustment – to remove any element of profit or loss based on holding payables or receivables in a period of inflation.

You do not need to know how to do these adjustments, but you can see that they attempt to deal with the areas where inflation can lead to 'holding gains'.

7.5 THE ADVANTAGES AND DISADVANTAGES OF CURRENT COST ACCOUNTING

7.5.1 ADVANTAGES

- By excluding holding gains from profit, CCA can be used to indicate whether the dividends paid to shareholders will reduce the operating capability of the business.
- Assets are valued after management has considered the opportunity cost of holding them, and the expected benefits from their future use. CCA is therefore a useful guide for management in deciding whether to hold or sell assets.
- It is relevant to the needs of information users in:
  - assessing the stability of the business entity;
  - assessing the vulnerability of the business (e.g. to a takeover), or the liquidity of the business;
  - evaluating the performance of management in maintaining and increasing the business substance; and
  - judging future prospects.
- It can be implemented fairly easily in practice, by making simple adjustments to the historical cost accounting profits. A current cost statement of financial position can also be prepared with reasonable simplicity.

7.5.2 DISADVANTAGES

- It is impossible to make valuations of EV or NRV without subjective judgments. The measurements used are therefore not objective.
- There are several problems to be overcome in deciding how to provide an estimate of replacement costs for non-current assets.
- The mixed value approach to valuation means that some assets will be valued at replacement cost, but others will be valued at NRV or EV. It is arguable that the total assets will, therefore, have an aggregate value which is not particularly meaningful because of this mixture of different concepts.
- It can be argued that 'deprival value' is an unrealistic concept, because the business entity has not been deprived of the use of the asset. This argument is one which would seem to reject the fundamental approach to 'capital maintenance' on which CCA is based.

KEY MODULE POINTS 1

- A basic principle of accounting is that transactions are normally stated in accounts at their historical amount.
- There are a variety of other possible methods of measurement:
  - fair value
  - deprival value
  - replacement cost
  - net realisable value
- The main advantage of historical cost accounting is that the cost is known and can be proved. There are also a number of disadvantages and these usually arise in times of rising prices (inflation). Other disadvantages have arisen as business practice and transactions have become more complex.
- An accounting theory refers to having a body of knowledge which sets out the rules and regulations to be followed in accounting for transactions. Accounting theories should guide accounting practice and form a basis for the future development of accounting standards. Two possible accounting theories are positive accounting theory and normative accounting theory.
- A number of alternatives to historical cost accounting have been developed and discussed. It is unlikely that the IASB will propose a full system of current cost accounting in the near future, but standards are requiring increasing use of fair values.
- An entity should select the concept of capital that is appropriate to the needs of the users of its financial statements.
- Two alternative systems which have sought in the past to address the shortcomings of historical cost accounting are current purchasing power (CPP) and current cost accounting (CCA).
- CPP measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.
- CCA reflects an approach to capital maintenance based on maintaining the operating capability of a business.

QUICK REVISION QUESTIONS 1

1 Which statement is correct of the historical cost convention?
   A It records only past transactions.
   B It fails to take account of changing price levels over time.
   C It has been replaced in accounting records by a system of current cost accounting.
   D It values all assets at their cost to the business, without any adjustment for depreciation.

2 Under what basis are assets usually valued?
   A historical cost
   B deprival value
   C replacement cost
   D net realisable value

3 In times of rising prices, what effect does the use of the historical cost concept have on a company's asset values and profit?
   A asset values and profit both overstated
   B asset values and profit both understated
   C asset values understated and profit overstated
   D asset values overstated and profit understated

4 Korbin Co. buys a machine for $50 000. It will generate income of $8000 per annum for 7 years. What is its economic value?
   A $8000
   B $42 000
   C $50 000
   D $56 000

5 Ladybird Co. is considering scrapping a machine for proceeds of $1000. Alternatively, it can spend $800 on the machine and receive sales proceeds of $1900. What is the net realisable value of the machine?
   A $200
   B $1000
   C $1100
   D $1900

6 Which of the following statements is correct?
   A Positive accounting theory is not based on actual accounting practice.
   B Normative accounting theory attempts to predict actual accounting practice.
   C The use of a conceptual framework is an example of positive accounting theory.
   D The development of alternatives to historic cost is an example of normative accounting theory.

7 What does the following statement describe?
   'The point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital.'
   A fair value
   B historical cost
   C capital maintenance
   D current cost accounting

8 Consider the following statements:

I. Specific price inflation is based on the average rate of inflation.

II. General price inflation measures price changes for a particular group of assets.

Which statements are correct?

A I only
B II only
C both I and II
D neither I nor II

9 Which of the following statements about current purchasing power accounting (CPP) are correct?

I. It measures profit as the increase in nominal money capital over the period.

II. It measures profit as the difference between income and expenses after allowing for the effect of inflation.

III. It measures profit as the difference between income and expenses after ensuring that physical capital has been maintained.

A II only
B III only
C I and II only
D I and III only

10 Which one of the following is **not** used as a measure of deprival value?

A fair value
B economic value
C replacement cost
D net realisable value

8 AGENCY THEORY

LO 2.2

Section overview

- **Agency** is extremely important in corporate governance as often the directors/managers are acting as agents for the owners of the entity. Corporate governance frameworks aim to ensure directors/managers **fulfil their responsibilities** as agents by requiring disclosure and suggesting they be rewarded on the basis of performance.

8.1 NATURE OF AGENCY

Definition

Agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent. (Jensen and Meckling)

There are a number of specific types of agent. These have either evolved in particular trades or developed in response to specific commercial needs. The most common in accounting is the relationship between directors and shareholders as the shareholders task the directors and management with running the company on their behalf.

8.2 ACCOUNTABILITY AND FIDUCIARY RESPONSIBILITIES

8.2.1 ACCOUNTABILITY

Definition

In the context of agency, accountability means that the agent is **answerable under the contract** to the principal and must account for the resources of the principal and the money gained working on the principal's behalf.

Potentially two problems arise with this:

1. How does the principal **enforce this accountability**? – this is the agency problem – see below; as we shall see, the corporate governance systems developed to monitor the behaviour of directors have been designed to address this issue.
2. What if the agent is **accountable to parties other than their principal**? – how does the agent reconcile possibly conflicting duties?

8.2.2 FIDUCIARY DUTY

Under common law it is usually the case that company directors owe a fiduciary duty to the company to exercise their powers in what they **honestly consider to be the interests** of the company. This duty is **owed to the company** and not generally to individual shareholders.

Clearly the concepts of fiduciary duty and accountability are very similar though not identical. Where certain wider responsibilities are laid down in law, do directors have a duty to go beyond the law, or can they regard the law as defining what society as a whole requires of them?

8.2.3 OTHER DUTIES

- The agent who agrees to act as an agent for a reward has a **contractual obligation** to perform their agreed task. An unpaid agent is not bound to carry out their agreed duties. Any agent may refuse to perform an illegal act.

- The agent must act strictly in **accordance with their principal's instructions** provided these are lawful and reasonable. Even if they believe disobedience to be in their principal's best interests, they may not disobey instructions. Only if they are asked to commit an illegal act may they do so.
- A paid agent undertakes to maintain the standard of **skill and care** to be expected of a person in their profession.
- The agent is typically selected because of their personal qualities and owes a duty to **perform their task themself** and not to delegate it to another. But they may delegate in a few special circumstances, if delegation is necessary, such as a solicitor acting for a client would be obliged to instruct a stockbroker to buy or sell listed securities on a stock exchange.
- The agent owes to their principal a duty not to put themself in a situation where their **own interests conflict** with those of the principal; for example, they must not sell their own property to the principal even if the sale is at a fair price.
- The agent must keep in **confidence** what they know of their principal's affairs even after the agency relationship has ceased.
- Any benefit must be handed over to the principal unless they **agree** that the agent may **retain it**. Although an agent is entitled to their agreed remuneration, they must account to the principal for any other **benefits**. If they accept from the other party any **commission or reward** as an inducement to make the contract with them, it is considered to be a bribe and the contract is fraudulent.

8.3 AGENCY IN THE CONTEXT OF THE DIRECTOR-SHAREHOLDER RELATIONSHIP

Agency is a significant issue in corporate governance because of the **dominance of the limited liability company**. For larger companies this has led to the **separation of ownership of the company** from its **management**. The owners (the shareholders) can be seen as the **principal**, the management of the company as the **agents**.

Although ordinary **shareholders** (equity shareholders) are the owners of the company to whom the board of directors are accountable as agents, the actual powers of shareholders tend to be restricted. They normally have no right to inspect the financial records, and their forecasts of future prospects are gleaned from the annual report and accounts, stockbrokers, journals and daily newspapers.

The day to day running of a company is the responsibility of the directors and other managers to whom the directors delegate, not the shareholders. For these reasons, therefore, there is the potential for **conflicts of interest** between management and shareholders.

8.4 THE AGENCY PROBLEM

The agency problem in limited liability companies derives from the principals (owners) not being able to run the business themselves and therefore having to rely on agents (directors) to do so for them. This **separation of ownership from management** can cause issues if there is a breach of trust by directors through intentional action, omission, neglect or incompetence. This breach may arise because the directors are **pursuing their own interests** rather than those of the shareholders or because they have **different attitudes to risk-taking** than the shareholders.

For example, if managers hold none or very little of the share capital of the company they work for, what is to stop them from working inefficiently, concentrating too much on achieving short-term profits and hence maximising their own bonuses, not bothering to look for profitable new investment opportunities, or giving themselves high salaries and benefits (e.g. bonuses and other benefits or advantages)?

One power that shareholders possess is the right to **remove the directors** from office. But shareholders have to take the initiative to do this, and in many companies, the shareholders lack the energy and organisation to take such a step. Ultimately they can vote in favour of a takeover or removal of individual directors or entire boards, but this may be undesirable for other reasons.

8.5 AGENCY COSTS

To alleviate the agency problem, shareholders have to take steps to exercise control, such as attending annual general meetings or ultimately becoming directors themselves. However, agency theory assumes that it will be **expensive and difficult** to:

- verify what the agent is doing, partly because the agent has more available information about their activities than the principal does; and
- introduce mechanisms to control the activities of the agent.

Agency costs arise therefore, from attempts by principals to monitor the activities of agents, and may be viewed in monetary terms, resources consumed or time taken in monitoring. There will also be costs involved in establishing methods of control such as contracts. These costs may not just be incurred by the shareholders. To fulfil the requirements imposed on them and to obtain the rewards of fulfilment, managers will spend time and resources proving that they are maximising shareholder value by, for example, providing increased disclosure.

Types of agency costs include salaries paid to directors in their role as agents running the company on shareholders' behalf. Additionally, the principal incurs **monitoring costs** to ensure that the agent is doing what they should be. This can include costs of preparing financial information including corporate governance reports, the cost of an external auditor who reports independently on the financial statements, and the internal audit function (if there is one). An agency cost can also include the shareholders' personal cost of accepting **higher risks** than they would perhaps wish to, as they are tasking the agent with running the business on their behalf.

8.6 RESOLVING THE AGENCY PROBLEM: ALIGNMENT OF INTERESTS

Agency theory sees employees of businesses, including managers, as individuals, each with their own objectives. Within a department of a business, there are departmental objectives. If achieving these various objectives leads also to the achievement of the objectives of the organisation as a whole, there is said to be **alignment of interests**.

Definition

Alignment of interests is agreement between the objectives of agents acting within an organisation and the objectives of the organisation as a whole. Alignment of interests is sometimes referred to as goal congruence, although goal congruence may also be used in other ways.

Alignment of interests may be better achieved and the 'agency problem' better dealt with by giving managers some profit-related pay, or by providing incentives that are related to profits or share price. Examples of such remuneration incentives are:

- **Profit-related/economic value-added pay**
  Pay or bonuses related to the size of profits.
- **Rewarding managers with shares**
  This might be done when a private company 'goes public' and managers are invited to subscribe for shares in the company at an attractive offer price. In a **management buy-out** or **buy-in** (the latter involving purchase of the business by new managers; the former by existing managers), managers become joint owner-managers.
- **Executive share option plans (ESOPs)**
  In a share option scheme, selected employees are given a number of share options, each of which gives the holder the right after a certain date to subscribe for shares in the company at a fixed price. The value of an option will increase if the company is successful and its share price goes up, therefore giving managers an incentive to make decisions to increase the value of the company, actions congruent with wider shareholder interests.

Such measures might merely encourage management to adopt '**creative accounting**' methods which will distort the reported performance of the company in the service of the managers' own ends. The global financial crisis has highlighted issues with the use of such remuneration incentives.

An alternative approach is to attempt to **monitor managers' behaviour**, for example by establishing **'management audit'** procedures, to introduce **additional reporting requirements**, or to seek **assurances** from managers that shareholders' interests will be foremost in their priorities. The most significant problem with monitoring is likely to be the agency costs involved, as they may imply significant shareholder engagement with the company.

Definition

Transparency means **open and clear disclosure** of relevant information to shareholders and other shareholders and also not concealing information when it may affect decisions. It means open discussions and a default position of information provision rather than concealment.

Disclosure in this context clearly includes information in the financial statements, not just the numbers and notes to the accounts but also narrative statements such as the directors' report and the operating and financial review. It also includes all **voluntary disclosure**, that is disclosure above the minimum required by law or regulation. Voluntary corporate communications include management forecasts, analysts' presentations, press releases, information placed on websites and other reports such as stand-alone environmental or social reports.

The main reason why transparency is so important relates to the agency problem discussed above, that of the potential conflict between owners and managers. Without effective disclosure the position could be unfairly weighted towards managers, since they have far more knowledge of the company's activities and financial situation than owners/investors. Avoidance of this **information asymmetry** requires not only effective disclosure rules, but strong internal controls that ensure that the information that is disclosed is **reliable**.

Linked with the agency issue, publication of relevant and reliable information **underpins stock market confidence** in how companies are being governed and therefore **significantly influences market prices**. **International accounting standards** and **stock market regulations** based on corporate governance codes, require information published to be **true and fair**. Information can only fulfil this requirement if adequate disclosure is made of uncertainties and adverse events.

Circumstances where concealment may be justified include discussions about **future strategy** (knowledge of which would benefit competitors), **confidential** issues relating to **individuals** and discussions leading to an agreed position that is then to be made public.

8.7 OTHER AGENCY RELATIONSHIPS

8.7.1 SHAREHOLDER-AUDITOR RELATIONSHIP

The shareholder-auditor relationship is another agency relationship on which **corporate governance guidance** has focused. The shareholders are the principals, the auditors are the agents and the auditor's report the key method of communication. The agency problem with auditors is that auditors may not be independent of management; they may become too close or are afraid that management will not give them more lucrative non-audit work. The Code of Ethics that applies to professional accounting bodies, such as CPA Australia, guards against such outcomes.

8.7.2 OTHER RELATIONSHIPS

Other significant agency relationships include directors themselves acting as principals to managers/employees as agents. It is, of course, a significant responsibility of directors to make sure that this agency relationship works by establishing **appropriate systems** of **performance measurement** and **monitoring**.

9 INFORMATION PROVIDED IN ANNUAL REPORTS

Section overview

- Reporting performance to shareholders is of key importance as a result of the agency issues discussed above. Because in many companies the shareholders are not involved in the day to day running of the company, shareholders and other shareholders rely on the annual report to provide them with essential information on which to base their investment and other decisions.

9.1 IMPORTANCE OF REPORTING

One key principle of good corporate governance is for companies to regularly engage in effective and fair communication with shareholders. Companies should aim to be as descriptive, detailed and forthcoming as possible.

Good disclosure helps reduce the gap between the information available to directors and the information available to shareholders, and therefore addresses one of the key difficulties of the agency relationship between directors and shareholders.

9.2 REPORTING REQUIREMENTS

Annual reports contain some information which is required by accounting standards or by legislation. Other information is included voluntarily.

9.2.1 MANDATORY INFORMATION

According to IAS 1 *Presentation of Financial Statements*, a complete set of financial statements includes the following components:

- statement of financial position;
- statement of profit or loss and other comprehensive income;
- statement of changes in equity;
- statement of cash flows;
- accounting policies and explanatory notes; and
- comparative information in respect of the preceding period.

The preparation of these statements is the responsibility of the **board of directors**. IAS 1 also encourages a **financial review** by management and the production of any other reports and statements which may aid users.

The **auditor's report** must also be disclosed with the financial statements as it provides an independent opinion as to whether the financial statements show a fair presentation/true and fair view of the performance and position of the entity and comply with relevant accounting standards.

Reporting requirements are also found in the **listing requirements of stock exchanges**, for example, in Australia the Australian Securities Exchange (ASX) Listing Rules. While these rules are not part of regulatory company supervision, companies who are listed on the ASX must comply with the Listing Rules. This is the same situation as the UK where the UK Corporate Governance Code is not a mandatory standard, but companies listed on the London Stock Exchange must prepare corporate governance disclosure, so for listed companies it becomes a mandatory requirement.

Corporate governance disclosure helps the shareholders understand the way the company is being run and ensures that the directors have proper procedures in place to deal with accountability, audits, directors' roles and responsibilities, internal control and relations with shareholders. The disclosures should explain how the company achieves good corporate governance and should clearly state instances where the company fails to meet the recommendations of the relevant corporate governance code, for example, if there is no audit committee.

9.2.2 NON-MANDATORY INFORMATION

There has been an increasing trend for companies to provide a great deal of additional information in their annual report. This information is largely voluntary and is disclosed in order to improve transparency and accountability to shareholders. A company may also take into account the information wishes of other shareholders such as the local community, environmental pressure groups, local government and employees. All this means that a company may be reporting to more than just shareholders and therefore the amount of information disclosed can be very large indeed.

There are a number of different areas of **non-mandatory disclosure**:

- **Social and environmental reporting** or **sustainability reporting,** which includes the nature and extent of social, transformation, ethical, safety, health and environmental management policies and practices.
- A business review such as the **management commentary** which should set out the directors' analysis of the current and proposed future performance of the business. It should include discussion and interpretation of the performance of the business and the future risks and prospects of the company. Note that although this is not required by legislation or accounting standards, and so not mandatory in that sense, a management commentary is required for listed companies in many jurisdictions, including Australia, in order to comply with relevant Stock Exchange requirements.
- **Risk information** – this may detail the work of the risk committee whose role is to identify, assess and minimise risks facing the organisation.

9.2.3 ADVANTAGES AND DISADVANTAGES OF DISCLOSING NON-MANDATORY INFORMATION

Disclosing information voluntarily, going beyond what is required by law or listing rules, can be **advantageous** for the following reasons:

- **Wider information provision**

  Disclosures covering wider areas than those required by law or regulations should give shareholders a better idea of the environment within which the company is operating and how it is responding to that environment. This should enable investors to carry out a more informed analysis of the strategies the company is pursuing, reducing information asymmetry between directors and shareholders. (Information asymmetry exists where some shareholders of an entity have access to more or better information than others.)

- **Different focus of information**

  Voluntary information can be focused on future strategies and objectives, giving readers a different perspective from compulsory information that tends to be focused on historical accounting data.

- **Assurance about management**

  Voluntary information provides investors with further yardsticks to judge the performance of management. Its disclosure demonstrates to shareholders that managers are actively concerned with all aspects of the company's performance.

While the provision of detailed information can be very useful and goes a long way towards achieving the corporate governance principles of transparency and accountability, the **downside** is that there is such a large amount of information that some shareholders may experience 'information overload'. In response to this, many companies ask shareholders if they want to receive a summarised annual report and accounts, and then publish the full report and accounts plus the other voluntary information on their website. This allows users to choose how much they want to read.

For example, Tesco plc, a UK supermarket group, has a vast amount of information on its corporate website, but users can create their own report by only selecting the information they wish to read and therefore avoid the information they are not interested in.

Many of the top 20 Australian publicly listed companies allow shareholders to view annual reports interactively online. This means they can access any annual report or financial statement and launch interactive features allowing them to navigate through the report or statement as they wish.

Companies providing this feature include BHP Billiton Ltd, Telstra Corporation Ltd., Wesfarmers Ltd., the Westfield Group and Woolworths Ltd.

Other **disadvantages** of the disclosure of non-mandatory information include the following:

- **Costs of preparation**
  The costs of assimilating information in respect of environmental and similar issues may far outweigh any benefit which the company receives as a result of disclosure.
- **Loss of competitive advantage**
  Particularly where disclosure includes detail of future strategies and objectives, competitors may gain useful knowledge about a company which they use to improve their own position in the market.
- **Usefulness of information**
  There is an argument that non-financial non-mandatory information is irrelevant to investors who are more interested in financial factors in order to asses the return on their investment. Equally, such information can generally not be compared with like information for other entities due to the varied performance measures and presentation used.

10 INFORMATION AVAILABLE TO SHAREHOLDERS

Section overview

- Information available to shareholders comes from a wide variety of sources, including financial statements, the financial press and the internet.
- Companies have many incentives to provide information. Management needs to communicate with shareholders, their advisers and the wider public.

10.1 AVAILABILITY OF INFORMATION

Information comes from financial statements, financial databases, the financial press and the internet. Information provided directly by the company may include:

- annual financial report;
- chairman's statement;
- directors' report;
- corporate governance statement;
- corporate social responsibility report;
- auditors' report; and/or
- management commentary.

10.2 BENEFITS OF PROVIDING COMPANY INFORMATION TO SHAREHOLDERS

Earlier in this module, we looked at some of the benefits of disclosing more information than is actually required by law, accounting standards or other regulations. Later in this module we will look in more detail at some of the additional information that large listed companies provide to the public as part of, or alongside, their annual report. Some of this information, such as corporate governance disclosures, may be required by listing authorities. However, other information, such as a corporate social responsibility reports, is largely provided voluntarily.

There is an argument that companies provide such information partly through 'peer pressure'. Once a certain number of organisations are providing a certain type of disclosure, this becomes accepted 'best practice'. 20 years ago, a relatively small number of organisations published an environmental report, now, most large listed companies do so.

There are other powerful incentives in place to provide information and these are connected with the need for a company's management to communicate with shareholders, their advisers and the wider public:

- Conventional financial statements have limitations

  They provide historical information, whereas managers and investors need to predict future performance. Financial statements only recognise monetary transactions and assets and liabilities that can be measured reliably at a monetary amount. Many organisations are successful as a result of their intangible assets: technical expertise; patents; software design; human and intellectual capital. Additional narrative reports enable management to explain a company's future prospects and the significance of items that do not appear in the main financial statements.

- Complexity and uncertainty

  Business operations are complex and affected by changes in the wider economic and political environment. Management needs to explain the risks and uncertainties that could affect a company's future performance and position and the actions that it is taking to manage them.

- Openness and transparency

  Full disclosure implies that management has nothing to hide and can be trusted. There is an argument that it is better to disclose 'bad news' than no information at all, particularly as disclosure provides an opportunity to explain the reasons for a poor performance and to describe the action that is being taken to ensure that future results will be better.

Information about a company affects share prices. Voluntary disclosure gives management an opportunity to control the supply of information and to manage its impact on investors, analysts and the wider public. A company's reputation may be damaged if it fails to disclose bad news in a timely manner. Silence may lead the market to assume that a company's situation is very much worse than it actually is.

Question 5: Bad news

Hemlock is a listed entity involved in the business of oil exploration, drilling and refining. The business has been consistently profitable, creating high returns for its international shareholders. Two years ago, an environmental group based in Overland started lobbying the government to take action against Hemlock for alleged destruction of valuable wildlife habitats in Overland's protected wetlands and the displacement of the local population. Hemlock's legal advisers assessed the risk of liability at less than 50 per cent. A contingent liability of $250 million was noted in the financial statements to cover possible fines, legal costs, compensation to displaced persons and reinstatement of the habitats.

Hemlock is currently preparing its financial statements for the year ended 31 December 20X9. Recent advice from the entity's legal advisers has assessed that the risk of a successful action against Hemlock has increased, and must now be regarded as more likely than not to occur. The directors accept that a provision of $250 million is required. The draft financial statements show that without the provision, operating profit margin and earnings per share both show a substantial increase on the previous year. However, recognising the provision will have an adverse effect on the financial statements for 20X9. Although the reported result for the year will still be a profit, both operating profit and earnings per share will be significantly lower than the comparative amounts for 20X8.

The directors are concerned about the potentially adverse effect on the share price. In addition, they feel that the reputation of the company will probably be damaged. The Chief Executive makes the following suggestion:

> We should publish an environmental and social report. Most of our competitors do this now. This would give us the opportunity to publicise the many good things that we do to care for the environment and it might help to deflect some of the public attention from us over the problems in Overland. It would be a good public relations opportunity as well; we can use it to tell people about our work with charities and our equal opportunities program. We could probably pull something together to go out with this year's annual report.

Required

(a) Briefly discuss the directors' view that the company's share price and its reputation will be adversely affected as a result of recognising the provision in the financial statements for 20X9.

(b) Identify the advantages and disadvantages to Hemlock of adopting the Chief Executive's proposal to publish an environmental and social report.

(The answer is at the end of the module.)

11 CONTENT OF COMPANY REPORTS

Section overview

- The annual financial report consists of the main financial statements together with notes and other explanatory material.
- Other information provided with the annual financial report may include the following:
  - Chairman's statement
  - Directors' report
  - Corporate governance statement
  - Corporate social responsibility report
  - Auditor's report
  - Management commentary.

11.1 ANNUAL FINANCIAL REPORT

The annual financial report consists of the main **financial statements together with notes** and other explanatory material. The primary statements are cross-referenced to the notes.

IAS 1 explains that the notes are normally presented in the following order:

1. a **statement of compliance** with IFRSs
2. a summary of **significant accounting policies** adopted
3. **supporting information** for items presented in the primary statements in the order in which each statement and each line item is presented
4. **other disclosures**, including details of the company's contingent liabilities and contractual commitments not recognised in the financial statements; and non-financial disclosures, such as the company's policies for managing risk connected with its financial instruments

The disclosures relating to accounting policies should include details of any **significant judgments** that management has made in applying the policies chosen, assumptions that it has made about the future and of other **major sources of estimation uncertainty** at the end of the reporting period.

11.2 CHAIRMAN'S STATEMENT

This is usually a fairly brief overview of the key achievements of the company in the period. The statement is **voluntary** and in theory it can contain whatever information the Chairman or the management wish. It may be used to provide users with important information about the future strategy of the company, but it **normally emphasises the positive aspects of the company's performance** in the past year. It may include some summary financial information or non-financial measures (often presented as graphs or charts) or it may consist entirely of narrative content. The Chairman's statement can be incorporated as part of the Directors' report as is commonly the case with the annual reports of Australian companies.

11.3 DIRECTORS' REPORT

In many countries, including Australia and the UK, the content of the Directors' report is prescribed by companies legislation. In Australia, the Corporations Act 2001 requires that the report must include general information about the company and its activities, including:

- a **review of its operations** during the year and the results of those operations;
- details of any **significant changes** in the entity's state of affairs during the year;
- the entity's **principal activities** during the year and any significant changes in the nature of those activities during the year;
- details of any matter or circumstance that has **arisen since the end of the year** that has significantly affected, or may significantly affect the entity's operations in future financial years; and
- details of **likely developments** in the entity's operations in **future financial years** and the expected results of those operations.

The directors' report must also include:

- **dividends** paid during the year; and
- the **name of each person who has been a director** of the company during the year.

Public and/or listed companies may be required to disclose additional information about each director's qualifications, experience or special responsibilities; their attendance at board and committee meetings during the year; and their interests in the company's shares, debentures, or share options.

In many jurisdictions, including Australia, the directors' report must also include detailed disclosures about **directors' remuneration**, including performance related remuneration (for example, bonus payments dependent on the company's results or movements in its share price). In some jurisdictions, this information may be provided in a separate report, or as part of corporate governance disclosures (see below).

Question 6: Purpose of the directors' report

The **only** objective of general purpose financial reporting is to provide existing and potential investors, lenders and other creditors with information that is useful in making economic decisions.

Required

In relation to the directors' report, is this statement correct or incorrect?

(The answer is at the end of the module.)

11.4 CORPORATE GOVERNANCE STATEMENT

Corporate governance is the system by which companies are directed and controlled.

Definition

Corporate governance is the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It encompasses the mechanisms by which companies, and those in control, are held to account. *(Australian Securities Exchange)*

The directors are responsible for the governance of their companies. Most listing authorities require companies to comply with codes of corporate governance as a condition of listing. A code of corporate governance **requires the directors to set up a system of controls and procedures** to ensure that the company is **being run effectively for the benefit of the shareholders**.

Listed companies must include a corporate governance statement in their annual report. Many listing authorities, including the ASX and the London Stock Exchange, have adopted the 'if not, why not?' approach, whereby companies are required to disclose the extent to which they have followed the recommendations or principles set out in the Code in the reporting period. Where companies have not followed all the recommendations, they must identify those that have not been followed and give reasons for not following them. Other listing authorities may require a different approach.

The ASX sets out eight fundamental principles of corporate governance in its Corporate Governance Principles and Recommendations document which is to:

1. lay solid foundations for management and oversight
2. structure the board to add value
3. act ethically and responsibly
4. safeguard integrity in corporate reporting
5. make timely and balanced disclosure
6. respect the rights of security holders
7. recognise and manage risk
8. remunerate fairly and responsibly.

In practice the corporate governance guidance includes descriptions of the roles and responsibilities of the directors, procedures put in place to maintain the independence of non-executive directors, relationships with external auditors, investors and other key shareholders. It shows the members of the board who sit on the various committees, such as audit, remuneration and nomination committees. It also describes and explains the systems that the directors have put in place to manage risk, including the company's internal control systems.

11.5 CORPORATE SOCIAL RESPONSIBILITY REPORT

Most large listed entities present a corporate social responsibility report of some kind, either as part of their annual report, or as a stand-alone document. The corporate social responsibility report provides information about the way in which a company's activities **have affected the natural environment** and the **community in which it operates**. It describes and explains the actions it has taken to safeguard the environment and to act in an ethical and socially responsible manner towards its employees and other people affected by its activities.

Corporate social responsibility reports may be called **environmental, social or sustainability reports**. Information about corporate social responsibility may also be included in the directors' report (see above) or in the management commentary (see below).

Most jurisdictions now encourage companies to provide information and companies legislation may contain limited reporting requirements. In the UK, quoted companies must include information about the impact of the company's business on the environment; the company's employees; and information about social and community issues in the directors' report. However, most corporate social responsibility reporting is **voluntary**. Although there are a number of published guidelines and codes of practice (of which the most important are the *Sustainability Reporting Guidelines* published by the Global Reporting Initiative (GRI)), there are **no disclosure or reporting requirements within IFRS**. Therefore companies **can disclose whatever information they wish** or as much or as little as they wish.

While some reports are mainly public relations exercises, many now provide useful information, including key performance measures, with comparatives for previous periods. Many companies now present reports that have been audited or accredited under the GRI or similar guidelines.

Case study: Sustainability report

Below is an extract from the 2012 Sustainability Report of Origin Energy, a company included in the Dow Jones Sustainability Asia Pacific Index and the FTSE 4 Good Index. This report is a separate stand-alone report, intended for a wide range of shareholders including shareholders, customers, communities and employees. It includes photographs, diagrams, charts and a glossary. It reports the company's progress against a series of five year objectives that were set in 2007.

Our Commitment: Respect the rights and interests of the communities in which we operate, by listening to them, understanding and managing the environmental, economic and social impacts of our activities.

ENERGY FOR OUR COMMUNITIES

The breadth of Origin's activities brings us into contact with a diverse range of communities in Australia, and increasingly in other parts of the world. We engage with community representatives ranging from governments and media through to non-government organisations, local community groups and individuals to help create shared value.

To deliver on our community-related objectives, we laid out a series of 5-Year Strategies, which we report against in this section. Given 2012 was the last year of our 5-Year Strategies, this year we also report whether we achieved what we set out to do.

5-Year Strategies

1. Contribute to a policy and industry response to climate change that delivers an effective pricing regime for carbon.

After a number of years of consultation and a lack of policy certainty, legislation was passed during the 2012 financial year to implement the Carbon Pricing Mechanism, which came into effect on 1 July 2012. Under the Commonwealth Government's Clean Energy Future legislation, the Carbon Pricing Mechanism will have a fixed price for the first three years (starting at $23 per tonne of CO_2e for the 2013 financial year) before moving to a floating price scheme from the 2016 financial year.

Origin has been a long time supporter of an emissions trading scheme as the least cost means of achieving Australia's stated and bipartisan 2020 emissions target of a five per cent carbon reduction on 2000 levels. This support has been in the context of a package of measures which also includes the Renewable Energy Target (RET), funding for emerging renewable technologies and transitional complementary policy measures as required, for example harmonised energy efficiency policies.

In the lead up to 1 July 2012, Origin was actively focused on establishing systems to comply with the Carbon Pricing Mechanism to support us in meeting our carbon liabilities from 1 July 2012.

Simultaneously, Origin has continued to advocate for the rationalisation of the range of other green schemes that exist and impose costs for industry and consumers.

The future of the Carbon Pricing Mechanism and some of the complementary measures in Australia remains uncertain and these are ultimately decisions for governments.

2. Reduce the greenhouse gas emissions intensity of our electricity supply chain to 10 per cent less than the National Electricity Market by 2020.

In the 2012 financial year, the emissions intensity of the electricity supplied to customers was 4.1 per cent [1] below the NEM. This result was driven by an increased proportion of market (NEM) purchased electricity for a larger customer base in NSW following the acquisition of the NSW retail businesses, Integral Energy and Country Energy.

Our progress since establishing this target has been significant due to the contributions of our gas-fired generation portfolio, however, we are still tracking below our target given the growing demand for energy and the need for us to purchase large amounts of electricity from the NEM to service the increased customer base.

Reflecting over the past five years, the environment in which we operate has changed and now includes an emissions trading scheme. The introduction of the Clean Energy Future Package and a range of energy efficiency measures will impact

(1) Based on Origin's estimate of the full fuel cycle of NEM generation and Origin operated generation. The methodology incorporates NEM purchases and Origin generation only.

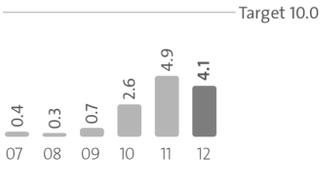
1
Origin aims to achieve positive community relationships.

2
Australia Pacific LNG's Talinga water treatment facility.

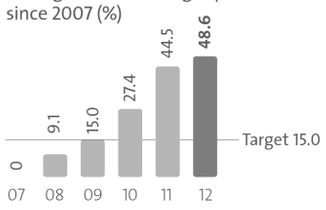
5-YEAR OBJECTIVES

- TO TAKE ALL FEASIBLE STEPS TO ELIMINATE OR MINIMISE ANY ADVERSE IMPACT THAT OUR ACTIVITIES HAVE ON THE ENVIRONMENT;
- TO REDUCE THE GREENHOUSE GAS INTENSITY OF OUR ENERGY PRODUCTION AND DISTRIBUTION AND NON-PRODUCING ASSETS; AND
- TO MAINTAIN COMMUNITY SUPPORT AND GOODWILL FOR THE COMPANY'S ACTIVITIES.

1. Emissions intensity of supply chain below the NEM since 2007 (%)



2. Reduction in emissions intensity of Origin's Australian gas production since 2007 (%)



supply and demand initiatives in the market creating opportunities and challenges for our operations into the future. See Graph 1 for our performance over the past five years.

3. Reduce the greenhouse gas emissions intensity of our gas production by 15 per cent by 2012.

As forecast, we exceeded this target in the 2012 financial year. We first achieved this commitment in 2009 and since then have continued to further reduce the greenhouse gas emissions intensity of our gas production year-on-year.

Origin's emissions intensity for the 2012 financial year was 5.66 $ktCO_2$-e/PJe, a 7.4 per cent improvement on the prior year and 48.6 per cent below the Company's 2007 emissions intensity of 11.0 $ktCO_2$-e/PJe. The shutdown of the BassGas facility due to the Yolla Mid Life Enhancement (MLE) project contributed to the reduction in emissions during the period as did lower production at the Spring Gully gas plant in Queensland. The shutdown of the BassGas facility due to the Yolla Mid Life Enhancement (MLE) project contributed to the slight reduction in emissions intensity; however, other assets on average delivered no significant change in intensity. See Graph 2 for information on this target.

4. Reduce or offset all greenhouse gas emissions from our non-energy producing sites.

During the 2012 financial year, Origin again achieved its commitment to offset 100 per cent of greenhouse gas emissions from our non-energy producing sites, such as emissions related to commercial offices as well as car and air travel. This commitment was achieved through a mix of accredited GreenPower and eligible voluntary offset certificates under Origin's Carbon Pollution Reduction Scheme.

Between July and December 2011, Origin purchased accredited GreenPower products to offset 10 per cent of the greenhouse gas emissions associated with electricity consumption in our offices, shops and LPG terminals. For the remaining 90 per cent of emissions, as well as all emissions from business travel, Carbon Offsets were sourced from accredited projects under Origin's Carbon Pollution Reduction Scheme. Between January and June 2012, we offset 90 per cent of emissions from our non-energy producing sites with voluntary offset certificates and the remaining 10 per cent of emissions were offset with GreenPower.

This commitment was achieved consistently across the five year period.

5. Identify opportunities for the reduction and re-use of waste.

Origin is committed to minimising the consumption of resources and generation of waste materials wherever possible across all business units. An increase in Origin's operational activities over the past year led to an overall increase in quantities of hazardous wastes and waste oil. Recycling rates for waste oil and other hazardous wastes continues to be higher than 90 per cent. Longer term efforts to reduce general waste are taking effect as recycling rates grow.

Salt is one of the key waste products associated with CSG production, given the water extracted with the gas is often very brackish. Currently, we treat CSG water via our reverse osmosis plants, producing treated water and a concentrated brine waste product. Origin, as Upstream operator of Australia Pacific LNG's project, is currently evaluating a wide range of disposal options for the salt. As part of our considerations, we are investigating the potential for Australia Pacific LNG to sell the salt in the form of products such as sodium chloride or soda ash or injecting the saline solution into very deep, isolated geological reservoirs that are not used as water supply aquifers.

Origin also continues to investigate ways to manage water produced through CSG operations. More information on this topic is provided in the Australia Pacific LNG case study on page 25.

ENERGY FOR OUR COMMUNITIES (CONTINUED)

Over the past five years, notwithstanding the increase in waste quantities due to the increase in the number and size of Origin's activities, the Company has diligently investigated and identified opportunities to reduce and re-use waste.

6. Rehabilitate or look for opportunities to offset land we have disturbed.

During the period, Origin newly disturbed 229 hectares of land and rehabilitated approximately 92 hectares. Land disturbance and land rehabilitation will vary from year to year based on the nature and extent of activities being conducted, including drilling and exploration activities, pipe laying and site construction works.

Origin continues to implement new strategies to minimise and manage our land disturbance and rehabilitation. We use innovative new hybrid coil drilling rigs for our CSG operations which disturb approximately one tenth of the land of conventional rigs. Three hybrid coil drilling rigs are currently in use drilling CSG production wells for Phase 1 of the Australia Pacific LNG development program [1].

Origin's overall land disturbance ratio is forecast to decrease over the next few years as Australia Pacific LNG's project ramps up.

Over the five year period, disturbed land has been progressively rehabilitated. We continue to look for opportunities to minimise the land that is disturbed and adopt strategies to offset any disturbance.

7. Actively consult with the community at all locations where Origin has a material impact.

Over the past year, Origin has updated its process for engaging with the communities where we are conducting our activities. The community engagement process is underpinned by rigorous social and economic analysis and strong relationships that enable us to better understand and interact with the communities in which we work. The Community Engagement Directive defines the minimum mandatory requirements for the development of Origin community engagement programs, which have been established in line with relevant regulatory requirements, the Equator Principles and the performance standards of the International Finance Corporation.

Wherever possible, Origin recruits our community engagement personnel from local or nearby communities. They listen to and learn from community members to understand their concerns and they also work with the community to identify investment opportunities to contribute to initiatives that deliver meaningful benefits.

Our community engagement programs include activities ranging from information sharing, to engagement and collaboration. Engagement mechanisms include flyers, fact sheets, interactive models, presentations and websites, free call numbers, shop fronts and information sessions. These tools are used in conjunction with face-to-face engagements such as meetings with community members, and multi-stakeholder forums such as community reference or consultative groups.

In 2012, we participated in community consultative groups domestically associated with our BassGas facility, Otway Gas Plant, Mortlake Power Station, the Cullerin Range Wind Farm, the Ironbark CSG development project and our Townsville operations and internationally associated with Energía Austral SpA (EAL)'s planned 1,000 MW hydroelectric projects in the Aysén Region in southern Chile. We also took part in four consultative committees for Australia Pacific LNG's project. During the year, a new community reference group was established for the Halladale and Blackwatch development project located offshore Victoria.

These groups provide a collaborative approach to consultation and communication and help establish positive working relationships with communities. The dialogue opened by the community reference group approach encourages two-way communication and provides an opportunity for community voices to be heard. These groups play a key role in identifying possible community investment options and advice in awarding our community grants.

Over the five years since 2007, we have increased the number of dedicated, locally-based community engagement personnel and, as a result, the level of communication with these communities has increased and deepened.

(1) Origin is a 37.5 per cent shareholder in Australia Pacific LNG and is operator for the upstream segment of Australia Pacific LNG's CSG to LNG export project.

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You may like to compare this report with that of Newcrest Mining Limited www.newcrest.com.au. Newcrest Mining reports under the GRI Sustainability Reporting Guidelines, which are extremely detailed and cover three areas: Economic Performance, Environmental Performance and Social Performance. The full report is very lengthy and probably intended to be read mainly by corporate investors and industry experts.

11.6 AUDITOR'S REPORT

The auditor's report sets out the auditor's opinion of the financial statements. It states whether, in the auditor's opinion, the financial statements show a true and fair view/fair presentation of the financial performance and financial position of the entity. The exact wording of the report is normally set out in auditing standards and guidelines.

The following is an example of an auditor's report per International Standards on Auditing (ISA), specifically ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements* (ISAs are outside the scope of the FAR syllabus):

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at 31 December 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern andusing the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee

that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit. We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards. From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as 'other reporting responsibilities') shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e. included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists. The engagement partner on the audit resulting in this independent auditor's

report is [name]. [Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

This is an unmodified (unqualified), or 'clean' audit report. The financial statements give a true and fair view.

Modified audit opinions are rare, and may arise due to material misstatements or a lack of sufficient appropriate audit evidence. Because of the potential damage to a company's reputation, management and auditors normally resolve any disagreements. The financial statements are adjusted if this is necessary. A modified audit opinion states that the financial statements give a true and fair view or a fair presentation except for a particular matter or matters. Where problems are pervasive (fundamental), the auditor can either disclaim an opinion (due to a lack of sufficient appropriate audit evidence that is both material and pervasive) or give an adverse opinion (due to a misstatement that is both material and pervasive).

11.7 MANAGEMENT COMMENTARY

Definition

A management commentary is a narrative report that relates to financial statements that have been prepared in accordance with IFRSs. Management commentary provides users with historical explanations of the amounts presented in the financial statements, specifically the entity's financial position, financial performance and cash flows. It also provides commentary on an entity's prospects and other information not presented in the financial statements. Management commentary also serves as a basis for understanding management's objectives and its strategies for achieving those objectives. *(IFRS Practice Statement: Management Commentary)*

Most listed companies present a management commentary of some kind. Although this is not required by IFRS or normally by companies legislation, it may be required by listing authorities and is generally regarded as best practice. A management commentary is sometimes called an **Operating and Financial Review** or a **Management Discussion and Analysis**.

The **purpose** of a management commentary is to provide users with information that helps them **place the related financial statements in context**. It explains management's view on not only **what has happened**, but also **why** management believes it has happened and what management believes the **implications are for the entity's future**.

The IASB has issued a Practice Statement *Management Commentary* that sets out general principles that should be followed when preparing management commentary and elements that should be included in it, but compliance is **not mandatory.** The Practice Statement does not prescribe the form and content of the report in detail because this will depend on the nature of the entity's business and its circumstances.

The **principles** are that management commentary should:

- provide management's view of the entity's performance, position and progress;
- supplement and complement the information in the financial statements; and
- include forward-looking information.

A management commentary should include information that is essential to an understanding of:

- the **nature** of the business;
- management's **objectives** and **strategies** for meeting those objectives;
- the entity's most significant **resources**, **risks** and **relationships**;
- the results of **operations** and **prospects;** and
- the **critical performance measures** and **indicators** that management uses to evaluate the entity's performance against stated objectives (sometimes called Key Performance Indicators or KPIs).

Case study: Bunnings (a Wesfarmers' business)

Below is an extract from the 2012 Annual Report of Wesfarmers Limited. The Annual Report includes a Finance Director's Review, a commentary on the group's results, cash flow, statement of financial position, debt management, equity management, dividend policy, risk management and internal control and assurance. The Annual Report then considers each of the company's main operations in turn using the same headings for each: the business (a brief description); strategy; results; year in brief; business sustainability; and outlook.

Home Improvement and Office Supplies

Bunnings

Bunnings continues to expand and improve its store network through ongoing investment in existing outlets, innovative merchandising initiatives and new store openings.

John Gillam, Home Improvement and Office Supplies Managing Director (right), with Nicky Triantafillidis, Activities Organiser, South Oakleigh, Victoria

The business

Bunnings is the leading retailer of home improvement and outdoor living products in Australia and New Zealand and a major supplier to project builders, commercial tradespeople and the housing industry.

Operating from a network of large warehouse stores, smaller format stores, trade centres and frame and truss manufacturing sites, Bunnings caters for consumer and commercial customers.

Strategy

Bunnings provides its customers with the widest range of home improvement and outdoor living products and is committed to delivering the best service and lowest prices every day. It sets out to attract high quality employees and to provide them with a safe and rewarding working environment.

Bunnings continues to expand and improve its store network through ongoing investment in existing outlets, innovative merchandising initiatives and new store openings. Bunnings has developed and continues to expand and enhance a network of trade centres to service major commercial customers.

Results

Operating revenue from Bunnings increased by 5.6 per cent to $7.2 billion for the full year, with trading revenue also increasing by 5.6 per cent. Earnings before interest and tax grew 4.9 per cent to $841 million.

Total store sales growth in Bunnings of 5.9 per cent was achieved during the year, with underlying store-on-store sales increasing by 3.9 per cent. Commercial sales were 6.9 per cent higher than in the comparative period. Sales growth for the full-year was achieved in both consumer and commercial areas, across most key trading regions. Particularly pleasing were the outcomes from merchandising initiatives, including the range reset project and operational work to further strengthen service and services. A strong focus on productivity and cost management supported investments in the customer offer and EBIT growth.

Year in brief

During the year 16 trading locations were opened, including 13 new warehouse stores, one smaller format store and two trade centres. At the end of the period there were 206 warehouses, 58 smaller format stores and 36 trade centres operating across Australia and New Zealand. Investment in bringing current merchandising standards into older parts of the network continued, together with category-specific upgrade work across the whole network.

Business sustainability

Work continued during the year towards long-term carbon footprint reduction initiatives to reduce energy usage and waste, and educating customers and team members on sustainable living choices. Although continued growth in new stores affected the business' total carbon footprint, carbon intensity remained stable at 3.4 CO_2e tonnes per $100,000 of revenue. Water consumption remained a priority, with rainwater tanks and capillary mats continuing to be rolled out in new warehouse stores, and hand watering in selected nurseries. Scheme water use was 869 megalitres, an increase of 19 per cent overall. Notwithstanding the significant expansion in the store network, the intensity of our water use has reduced 31 per cent compared to the intensity of water use five years ago.

Over the year, Bunnings supported more than 42,000 community activities through community group sausage sizzles, hands on do-it-yourself projects and renovations, local fundraising activities, community workshops and other activities. Support included more than 106,000 hours of team member support for activities and projects, product contributions and financial assistance. This involvement helped raise and contribute more than $27 million for local, regional and national charities and community organisations across Australia and New Zealand.

Disappointingly, safety performance did not improve during the year. The rolling 12-month all injuries frequency rate increased from 36.6 to 38.8. Bunnings continues to focus on team member safety by strengthening safety leadership across the business, reducing risks linked to known injury hot spots, improving safety for higher risk activities, and achieving better returns to work outcomes.

Outlook

The business is well-positioned for continued sales growth, through increased service levels, category development, network expansion and reinvestment, an improved light and heavy commercial offer, and the continued investment of productivity gains in lower prices to drive volume.

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KEY MODULE POINTS 2

- Agency is extremely important in corporate governance as often the directors/managers are acting as agents for the owners. Corporate governance frameworks aim to ensure directors/managers fulfil their responsibilities as agents by requiring disclosure and suggesting they be rewarded on the basis of performance.
- Annual reports must convey a fair and balanced view of the organisation. They should state whether the organisation has complied with governance regulations and codes. It is considered best practice to give specific disclosures about the board, internal control reviews, going concern status and relations with shareholders.
- Information provided by a company to its shareholders may come from the following sources, although this may vary in different jurisdictions:
  - annual financial report
  - chairman's statement
  - directors' report
  - corporate governance statement
  - corporate social responsibility report
  - auditor's report
  - management commentary
- Information may also be obtained from press reports, financial databases, the internet etc.

QUICK REVISION QUESTIONS 2

1 What does the following statement define?

'A contract under which one or more persons engage another person to perform some service on their behalf.'

A accountability
B agency theory
C principal theory
D substance over form

2 Fiduciary duty is

A the directors running a company on behalf of the shareholders.
B the need for directors to prepare financial statements that show a true and fair view.
C the need for directors to disclose their personal shareholding in a company they manage.
D the need for directors to act in the best interests of the company and not out of self-interest.

3 Which of the following are examples of agency costs?

I. directors' salaries
II. external audit fees
III. finance department salaries

A I only
B II only
C I and II only
D I, II and III

4 According to IAS 1 *Presentation of Financial Statements,* which of the following are mandatory disclosures in the annual financial report?

I. risk review
II. accounting policies
III. environmental report
IV. statement of profit or loss

A IV only
B II and IV only
C I, II and IV only
D I, II, III and IV

5 ABC Co. is a large company, listed on the ASX. Which of the following items is it required to prepare as part of its annual financial report?

I. a Chairman's Statement
II. a corporate governance report

A I only
B II only
C both I and II
D neither I nor II

6 Which of the following must be disclosed in a non-listed company's annual report?
   A accounting policies
   B environmental report
   C management commentary
   D corporate governance statement

ANSWERS TO QUICK REVISION QUESTIONS 1

1 B Under the historical cost convention, assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.

2 A Historical cost is the measurement basis most widely applied in financial statements.

3 C Assets will tend to be understated and profits overstated due to low depreciation charges.

4 D $8000 × 7 years = $56 000

5 C Proceeds $1900 less costs to sell of $800 = $1100

6 D Positive accounting theory is based on actual accounting practice. Normative accounting theory explains what **should** occur rather than predicting what actually does occur.

7 C Capital maintenance. An entity has maintained its capital if the net assets total at the end of the period is the same as that at the beginning of the period. If capital (assets less liabilities) is greater at the end of the period than at the beginning, the entity has made a profit.

8 D Specific price inflation measures price changes over time for a specific group of assets. General price inflation is the average rate of inflation that reduces the general purchasing power of money.

9 A Statement III refers to current cost accounting. Statement I refers to historical cost accounting.

10 A Deprival value is the lower of replacement cost and recoverable value. Recoverable value is the higher of sales value (net realisable value) and value in use (economic value).

ANSWERS TO QUICK REVISION QUESTIONS 2

1 B An agency relationship involves a contract under which the principals engage the agent to perform some service on their behalf and delegate some decision-making authority to the agent.

2 D Company directors owe a fiduciary duty to a company to exercise their powers in what they honestly consider to be the interests of the company. This duty is owed to the company and not generally to individual shareholders.

3 C Agency costs include:

- salaries paid to directors in their role as agents
- monitoring costs to ensure that the agent is doing what they should be (such as the costs of preparing financial information, the cost of an external auditor and the internal audit function).

4 B Other mandatory items include the statement of financial position, statement of cash flows and statement of changes in equity. Narrative reports such as a risk review and environmental report are not mandatory, however these may be included in the annual report.

5 B The corporate governance report is required as part of the listing rules. The Chairman's Statement is voluntary.

6 A Per IAS 1, accounting policies must be disclosed. Provision of a corporate governance statement would be good practice but as the company is unlisted it is not mandatory.

ANSWERS TO MODULE QUESTIONS

1 Deprival value is calculated as the lower of replacement cost and recoverable amount. Recoverable amount is the higher of economic value (value in use) and net realisable value.

Net realisable value is $18 000 (20 000 – 2000).

Economic value is $25 000.

Net (depreciated) replacement cost is $42 000 (60 000 × 7/10).

Recoverable amount is $25 000 (economic value).

Deprival value is $25 000 (economic value).

This is the value of the plant to the business because:

- The company can generate more cash from continuing to use the plant than from selling it (economic value is higher than net realisable amount).
- However, the company will not replace the plant, because this would cost more than it could obtain from continuing to use it in the business.

2 The answer is B.

The deprival value for Property II will be close to fair value.

For each option, is important to consider the replacement cost, net realisable value (NRV) and economic value (EV). The deprival value is the lower of the replacement cost and recoverable amount. In turn, the recoverable amount is the higher of NRV and EV. Typically, NRV will be fair value for these properties, being the price the property would sell for on the open market.

For Property II, deprival value will almost certainly be NRV. Given that the property is only held for capital gains, we don't expect economic returns to exceed NRV, and replacement cost will be close to NRV. Deprival value will therefore be close to fair value.

For Property I, deprival value will probably be depreciated replacement cost. EV for a school is likely to be higher, because the classrooms are involved in generating the majority of the profit. NRV may be lower, because specialised property is often difficult to sell – the buyer may have to make substantial alterations before it can be used. Our recoverable amount will therefore be EV, as this is higher than NRV. Our deprival value will then be depreciated replacement cost, as this is lower than the recoverable amount. This means that deprival value for Property I will be higher than fair value, represented by NRV.

3 Historical cost accounting makes extensive use of subjective estimates, for example, useful lives of assets, allowances for doubtful receivables and inventory valuation.

It can be argued that some users are confused by historical cost accounts. Non-accountants may believe that the statement of financial position shows the actual value of an entity's assets and liabilities, rather than their cost.

4 The approach is to prepare a CPP statement of profit or loss.

	$c	**$c**
Sales (6000 × 360/330)		6 545
Less cost of goods sold (5000 × 360/300)		6 000
		545
Loss on holding cash for 6 months*	(545)	
Gain by owing payables for 1 month**	60	
		485
CPP profit		60

* ($6000 × 360/330) – $6000 = $c 545

**($2100 × 360/350) – $2100 = $c 60

Note that under historic cost accounting the gross profit would be $1000 ($6000 – $5000).

5 (a) The directors are probably justified in fearing that the fall in operating profit will have an adverse effect on the share price in the short term, particularly as investors often look at earnings per share in isolation.

However, the company is still profitable. A contingent liability for the same amount was disclosed two years ago, so analysts will have had some warning that this situation might arise. It should also be clear that this is a 'one off' expense and that otherwise the company has performed strongly during the year. In the medium term the company's share price will probably recover. There may be advantages in getting the bad news over quickly; analysts may feel that it is better to be aware of the worst case scenario.

(b) Advantages of publishing an environmental and social report:

- It would probably enhance the company's reputation. Hemlock would appear to be responding to the information needs of all its shareholders, not just providers of capital.
- Ethical and 'green' issues are becoming increasingly important to customers, suppliers, employees and the general public. If Hemlock is genuinely able to demonstrate that it is aware of its corporate social responsibilities this may improve its performance and share price in the longer term.

Disadvantages of publishing an environmental and social report:

- If the report is to be taken seriously and to reflect well upon the company it must not be perceived as a public relations exercise but a genuine attempt to provide useful information. It must be at least as good as those of the company's competitors, otherwise it may damage Hemlock's reputation, rather than enhance it.
- The report will be time consuming and costly to prepare. It will not be possible to 'pull something together'. To be credible, the report should include performance indicators and these should remain the same from year to year, even if performance declines in those areas.

6 The statement is not correct. The directors' report does provide useful information for making economic decisions, but that is not its only purpose. The information disclosed helps shareholders to assess the stewardship of management. Investors need to know how efficiently and effectively the directors have discharged their responsibility to use the entity's resources to generate returns. In particular, the information about directors' remuneration is largely provided so that shareholders will be aware of any attempts by the directors to reward themselves excessively.

MODULE 3
FINANCIAL STATEMENTS

Learning objectives	Reference
Prepare and present the statement of profit or loss and other comprehensive income with appropriate disclosure in accordance with relevant accounting standards and policies	LO3.1
Prepare and present the statement of financial position with appropriate disclosure in accordance with relevant accounting standards and policies	LO3.2
Prepare and present the statement of cash flows in accordance with relevant accounting standards and policies	LO3.3
Demonstrate the ability to detect, investigate and correct discrepancies or particular items/events while matching the financial statements to supporting documentation	LO3.4

Topic list

1 IAS 1 *Presentation of Financial Statements*
2 Statement of financial position
3 Statement of profit or loss and other comprehensive income
4 Statement of changes in equity
5 Notes to the financial statements
6 IAS 7 *Statement of Cash Flows*
7 Preparing a statement of cash flows
8 Internal control, and the role of internal and external auditors

MODULE OUTLINE

The bulk of this Study Guide looks at the financial statements of limited liability companies, either single companies or groups.

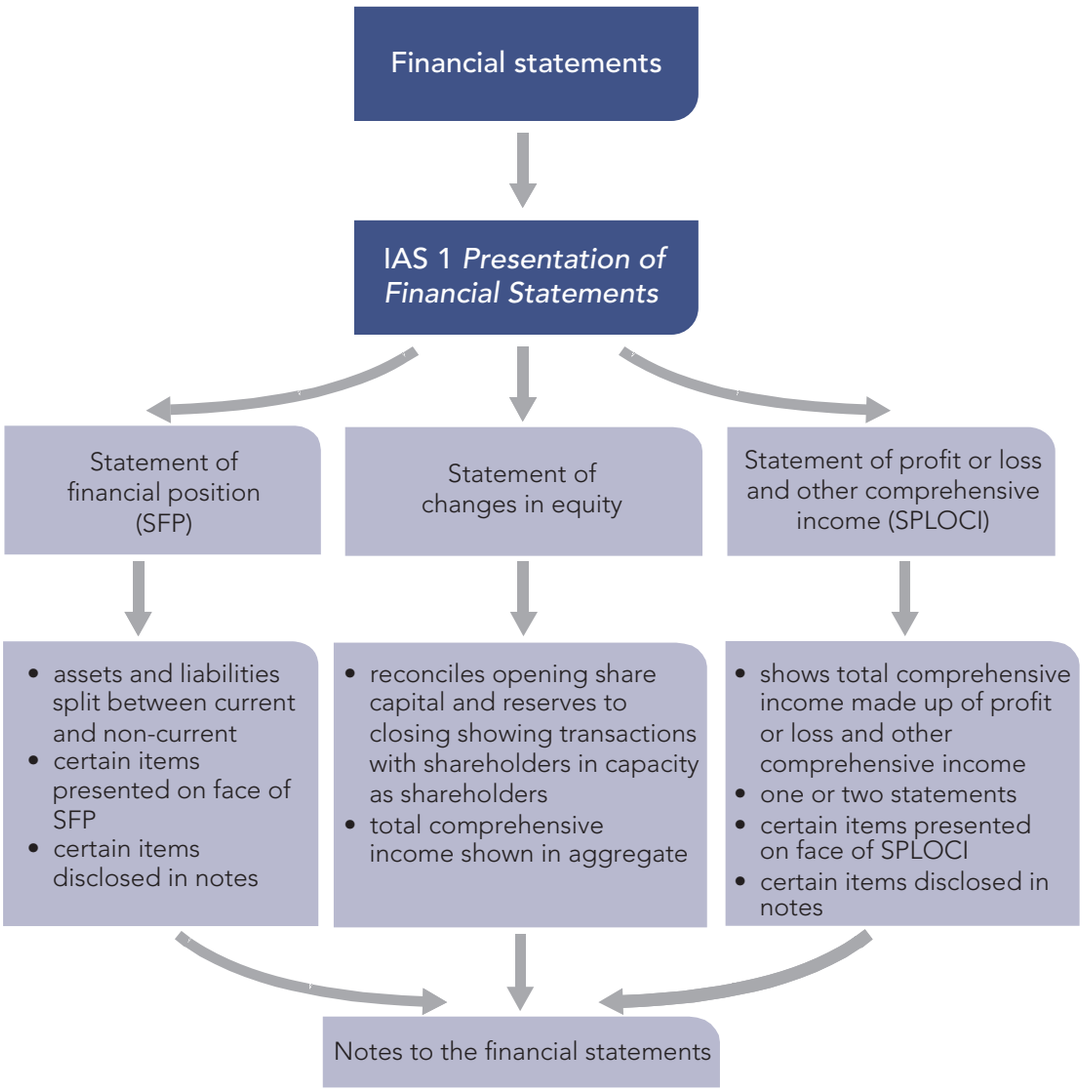
We begin this module by looking at the overall **content and format** of company financial statements. These are governed by IAS 1 *Presentation of Financial Statements*.

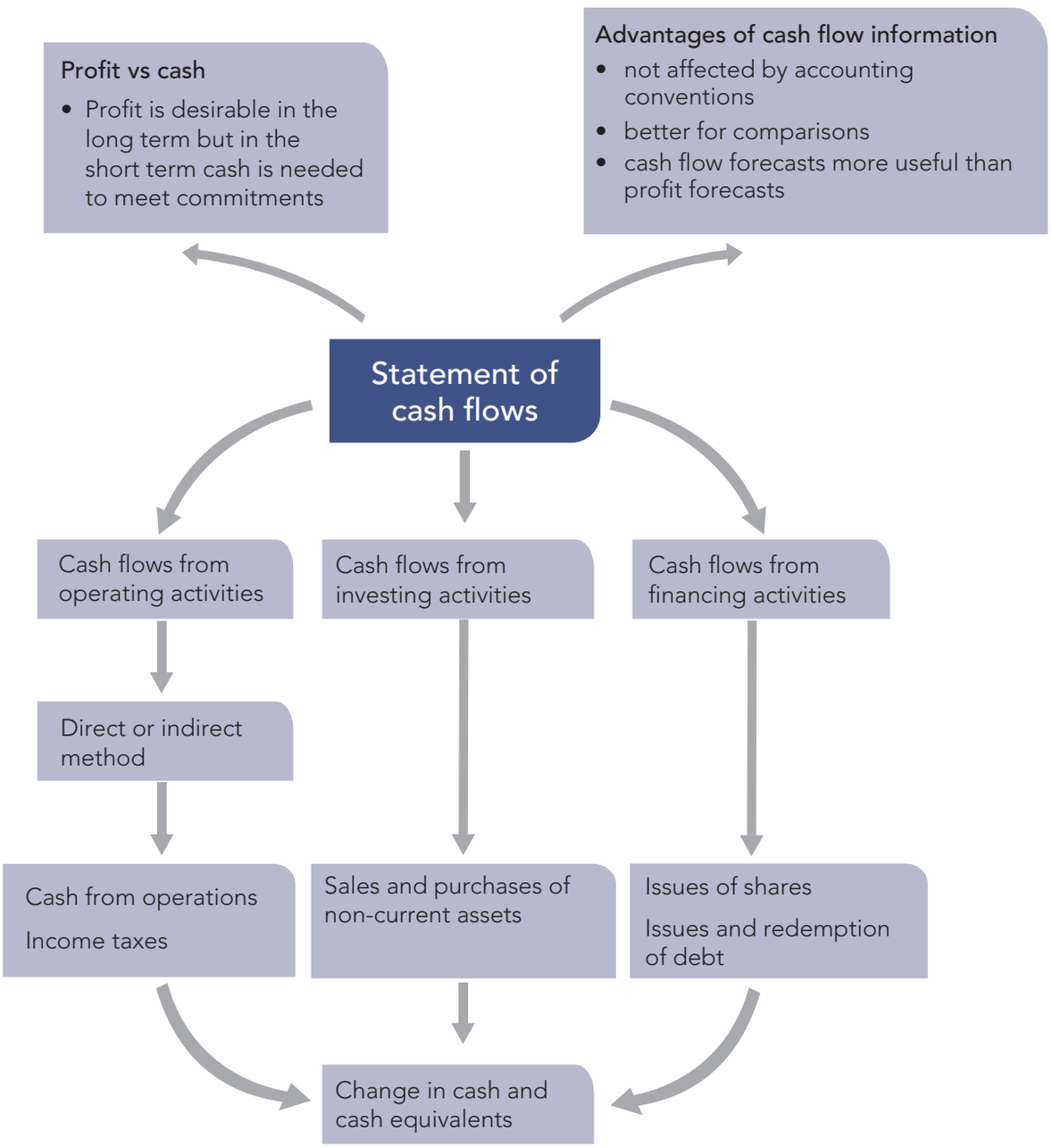
In the long run, a profit will result in an increase in the company's cash balance but, in the short run, **this will not necessarily be the case**. There is an important distinction between cash and profit. The statement of financial position and statement of profit or loss and other comprehensive income do not tell us whether the company has, or will be able to generate, sufficient cash to finance its operations. The importance of the **distinction between cash and profit** and the scant attention paid to this by the statement of profit or loss and other comprehensive income has resulted in the development of statements of cash flows.

This module adopts a systematic approach to the preparation of all the components of statements of cash flows in examinations; you should learn this method and you will then be equipped for all questions in the exam.

At the end of this module, we briefly look at internal control, and the role of internal and external auditors in the audit of an entity's financial statements.

The module content is summarised in the diagrams below.





Financial statements: Module summary diagrams

BEFORE YOU BEGIN

If you have studied these topics before, you may wonder whether you need to study this module in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the module to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the module you can find the information, and you will also find a commentary at the back of the Study Guide.

1 What items does IAS 1 require in a full set of financial statements? (Section 1)
2 When should an asset be classified as a current asset according to IAS 1? (Section 2.3.1)
3 When should a liability be classified as a current liability according to IAS 1? (Section 2.3.2)
4 What is total comprehensive income? (Section 3)
5 What is other comprehensive income? (Section 3)
6 Fill in the blanks: IAS 1 allows the presentation of total comprehensive income either
..... or ..... (Section 3.1)
7 Which items must be reported in the profit or loss section of the statement of profit or loss and other comprehensive income as a minimum according to IAS 1? (Section 3.2.2)
8 What is the purpose of a statement of changes in equity? (Section 4.1)
9 Why is a statement of cash flows useful to users of the financial statements? (Section 6)
10 What are cash equivalents? (Section 6.3 and 6.4)
11 What three classifications of cash flows are required by IAS 7? (Section 6.5)
12 How is cash generated by operations calculated using the direct method? (Section 6.6.1)
13 How is cash generated by operations calculated using the indirect method? (Section 6.6.2)
14 What are the advantages of cash flow accounting rather than accounting on an accruals basis? (Section 7.4)
15 What is the role of the internal and external auditors in the audit of an entity's financial statements? (Section 8)

1 IAS 1 *PRESENTATION OF FINANCIAL STATEMENTS*

LO 3.1

Section overview

- IAS 1 covers the form and content of financial statements. The main components are:
  - statement of financial position
  - statement of profit or loss and other comprehensive income
  - statement of changes in equity
  - statement of cash flows
  - notes to the financial statements

IAS 1 *Presentation of Financial Statements* gives substantial guidance on the form and content of published financial statements. The Standard looks at the statement of financial position and statement of profit or loss and other comprehensive income (the statement of cash flows is covered by IAS 7 *Statement of Cash Flows*, which we cover in detail in sections 6 and 7 of this module).

1.1 PROFIT OR LOSS FOR THE PERIOD

The statement of profit or loss and other comprehensive income shows a company's financial performance. So it is important to ensure that it is not misleading.

IAS 1 stipulates that all items of income and expense recognised in a period should be included in profit or loss unless a **Standard** or an **Interpretation** requires otherwise.

Circumstances where items may be excluded from profit or loss for the current year include the correction of errors and the effect of changes in accounting policies. These were covered in Module 1 when we looked at IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

1.2 HOW ITEMS ARE DISCLOSED

IAS 1 specifies disclosures of certain items in certain ways.

- Some items must appear in the statement of financial position or statement of profit or loss and other comprehensive income.
- Other items can appear in a **note to the financial statements** instead.
- **Recommended formats** are given.

Disclosures are specified by **other Standards** and we will mention the necessary disclosures when we cover each statement in turn. Disclosures required by IAS 1 and other Standards must be made either in the statement or in the notes unless otherwise stated, that is, disclosures cannot be made in an accompanying commentary or report. We will not give all the detailed disclosures as some are outside the scope of your syllabus.

1.3 IDENTIFICATION OF FINANCIAL STATEMENTS

It is most important that entities **distinguish the financial statements** very clearly from any other information published with them. This is because all IASs/IFRSs apply **only** to the financial statements (i.e. the main statements and related notes), so readers of the annual report must be able to differentiate between the parts of the report which are prepared under IFRSs, and other parts which are not.

The entity should **identify each** financial statement and the notes very clearly. IAS 1 also requires disclosure of the following information in a prominent position. If necessary, it should be repeated wherever it is felt to be of use to the reader in their understanding of the information presented.

- **name** of the reporting entity (or other means of identification)
- whether the accounts cover the **single entity** only or a group of entities
- the **date of the end of the reporting period** or the period covered by the financial statements (as appropriate)
- the **presentation currency (i.e. the currency in which amounts are presented)**
- the **level of rounding** used in presenting amounts in the financial statements.

Judgment must be used to determine the best method of presenting this information. In particular, the Standard suggests that the approach to this will be very different when the financial statements are communicated electronically.

The **level of rounding** is important, as presenting figures in thousands or millions of units makes the figures more understandable. The level of rounding must be disclosed, and it should not obscure necessary details or make the information less relevant.

1.4 REPORTING PERIOD

It is normal for entities to present financial statements **annually** and IAS 1 states that they should be prepared at least as often as this. If (unusually) the end of an entity's reporting period is changed, for whatever reason, the period for which the statements are presented will be less or more than one year. In such cases the entity should also disclose:

- the **reason(s) why** a period other than one year is used; and
- the fact that amounts presented in the financial statements are **not entirely comparable**.

For practical purposes, some entities prefer to use a period which **approximates to a year**, for example, 52 weeks, and IAS 1 allows this approach as it produces statements not materially different from those produced on an annual basis.

2 STATEMENT OF FINANCIAL POSITION

LO 3.2

Section overview

- IAS 1 specifies the line items to be presented in the statement of financial position.

2.1 STATEMENT OF FINANCIAL POSITION EXAMPLE

The example given by IAS 1 is as follows.

XYZ GROUP – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER

	20X7 $'000	20X6 $'000
Assets		
Non-current assets		
Property, plant and equipment	350 700	360 020
Goodwill	80 800	91 200
Other intangible assets	227 470	227 470
Investments in associates	100 150	110 770
Available-for-sale financial assets	142 500	156 000
	901 620	945 460
Current assets		
Inventories	135 230	132 500
Trade receivables	91 600	110 800
Other current assets	25 650	12 540
Cash and cash equivalents	312 400	322 900
	564 880	578 740
Total assets	1 466 500	1 524 200

	20X7 $'000	20X6 $'000
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	650 000	600 000
Retained earnings	243 500	161 700
Other components of equity	10 200	21 200
	903 700	782 900
Non-controlling interest	70 050	48 600
Total equity	973 750	831 500
Non-current liabilities		
Long-term borrowings	120 000	160 000
Deferred tax	28 800	26 040
Long-term provisions	28 850	52 240
Total non-current liabilities	177 650	238 280
Current liabilities		
Trade and other payables	115 100	187 620
Short-term borrowings	150 000	200 000
Current portion of long-term borrowings	10 000	20 000
Current tax payable	35 000	42 000
Short-term provisions	5 000	4 800
Total current liabilities	315 100	454 420
Total liabilities	492 750	692 700
Total equity and liabilities	1 466 500	1 524 200

IAS 1 specifies various items which must appear **in the statement of financial position** as a minimum disclosure, where applicable:

- property, plant and equipment (covered in the *Foundations of Accounting* Study Guide);
- investment property (outside the scope of the syllabus);
- intangible assets (Module 4);
- financial assets (excluding amounts shown under (e), (h) and (i)) (outside the scope of the syllabus);
- investments accounted for using the equity method (Module 5);
- biological assets (outside the scope of the syllabus);
- inventories (covered in the *Foundations of Accounting* Study Guide);
- trade and other receivables (assumed knowledge);
- cash and cash equivalents (sections 6 and 7);
- assets classified as held for sale under IFRS 5 (outside the scope of the syllabus);
- trade and other payables (assumed knowledge);
- provisions (outside the scope of the syllabus);
- financial liabilities (other than (k) and (l)) (outside the scope of the syllabus);
- current tax liabilities and assets as defined in IAS 12 (Module 4);
- deferred tax liabilities and assets (Module 4);
- liabilities included in disposal groups under IFRS 5 (outside the scope of the syllabus);
- non-controlling interests (Module 5); and
- issued capital and reserves (assumed knowledge).

Any **other line items**, headings or sub-totals should be shown in the statement of financial position when it is necessary for an understanding of the entity's financial position.

The example shown above is for illustration only (although we will follow the format in this Study Guide). The IAS does not prescribe the order or format in which the items listed should be presented. It simply states that they **must be presented separately** because they are so different in nature or function from each other.

2.2 INFORMATION PRESENTED EITHER IN THE STATEMENT OF FINANCIAL POSITION OR BY NOTE

Further **sub-classification** of the line items listed above should be disclosed either in the statement of financial position or in the notes. The classification will depend upon the nature of the entity's operations. As well as each item being sub-classified by its nature, any amounts payable to or receivable from any **group company** should also be disclosed separately.

Disclosures will vary from item to item and IAS 1 gives the following examples.

- **Property, plant and equipment** are classified by class as described in IAS 16 *Property, Plant and Equipment.*
- **Receivables** are analysed between amounts receivable from trade customers, other members of the group, receivables from related parties, prepayments and other amounts.
- **Inventories** are sub-classified, in accordance with IAS 2 *Inventories,* into classifications such as merchandise, production supplies, materials, work in progress and finished goods.
- **Provisions** are analysed showing separately provisions for employee benefits and any other items classified in a manner appropriate to the entity's operations.
- **Equity capital and reserves** are analysed showing separately the various classes of paid-in capital, and reserves.

The Standard then lists some **specific disclosures** which must be made, either in the statement of financial position or in the related notes.

- **Share capital disclosures** (for each class of share capital):
  - number of shares authorised;
  - number of shares issued and fully paid, and issued but not fully paid;
  - par value per share, or that the shares have no par value;
  - reconciliation of the number of shares outstanding at the beginning and at the end of the period;
  - rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
  - shares in the entity held by the entity itself or by related group companies; and
  - shares reserved for issue under options and sales contracts, including the terms and amounts.
- Description of the nature and purpose of **each reserve** within owners' equity.

Some types of entity have no share capital, for example, partnerships. Such entities should disclose information which is **equivalent** to that listed above. This means disclosing the movement during the period in each category of equity interest and any rights, preferences or restrictions attached to each category of equity interest.

2.3 THE CURRENT/NON-CURRENT DISTINCTION

An entity presents **current** and **non-current** assets as separate classifications in the statement of financial position.

2.3.1 CURRENT ASSETS

Definition

An asset should be classified as a current asset when it:

- is expected to be realised in, or is held for sale or consumption in, the normal course of the entity's operating cycle;
- is held primarily for trading purposes or for the short-term and expected to be realised within 12 months of the reporting period; or
- is cash or a cash equivalent asset which is not restricted in its use.

All other assets should be classified as non-current assets. *(IAS 1)*

Non-current assets include tangible, intangible, operating and financial assets of a long-term nature. Other terms with the same meaning can be used (e.g. 'fixed', 'long-term').

The term 'operating cycle' has been used several times above and the Standard defines it as follows.

Definition

The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. *(IAS 1)*

Current assets therefore include inventories and trade receivables that are sold, consumed and realised as part of the normal operating cycle. **This is the case even where they are not expected to be realised within 12 months**.

2.3.2 CURRENT LIABILITIES

Definition

A liability should be classified as a current liability when it either:

- is expected to be settled in the normal course of the entity's operating cycle;
- is held primarily for the purpose of trading;
- is due to be settled within 12 months after the reporting period; or
- the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period.

All other liabilities should be classified as non-current liabilities. *(IAS 1)*

The categorisation of current liabilities is very similar to that of current assets. Some current liabilities are part of the **working capital** used in the normal operating cycle of the business (i.e. trade payables and accruals for employee and other operating costs). Such items are classified as current liabilities **even where they are due to be settled more than 12 months after the end of the reporting period**.

There are also current liabilities which are not settled as part of the normal operating cycle, but which are due to be settled within 12 months of the end of the reporting period. These include bank overdrafts, income taxes, other non-trade payables and the current portion of interest-bearing liabilities. Any interest-bearing liabilities that are used to finance working capital on a long-term basis, and that are not due for settlement within 12 months, are classified as **non-current liabilities**.

3 STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

LO 3.1

Section overview

- IAS 1 requires all items of income and expense in a period to be shown in a **statement of profit or loss and other comprehensive income**.

The statement of profit or loss and other comprehensive income shows the entity's total comprehensive income.

'Profit or loss' is the total of income less expenses shown in the top half of the statement of profit or loss and other comprehensive income. This is sometimes called the statement of profit or loss.

'Other comprehensive income' comprises items of income and expense which other Standards do not allow or permit to be recognised in profit or loss.

IAS 1 provides a list of items which are classified as other comprehensive income. The following two are within the Financial Accounting and Reporting syllabus:

- revaluations of non-current assets (covered in the *Foundations of Accounting* Study Guide); and
- foreign exchange differences (covered in Module 4 of this Study Guide).

Other comprehensive income is grouped into items that will not be reclassified to profit or loss in the future and items that may be reclassified to profit or loss when specific conditions are met. Although the reclassification of other comprehensive income is not within your syllabus and should not concern you, you should be aware of the related presentation requirements of IAS 1.

3.1 STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME – FORMAT

IAS 1 allows total comprehensive income to be presented either:

(a) in a single statement of profit or loss and other comprehensive income; or

(b) in two statements: a statement of profit or loss and a statement of comprehensive income.

The format for a single statement of profit or loss and other comprehensive income provided in the Standard is shown below. The section down to 'profit for the year' can be shown as a separate 'statement of profit or loss' with an additional 'statement of comprehensive income'. Note that for completeness, this illustration includes some items that are not covered in this syllabus.

XYZ GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7 $'000	20X6 $'000
Revenue	390 000	355 000
Cost of sales	(245 000)	(230 000)
Gross profit	145 000	125 000
Other income	20 667	11 300
Distribution costs	(9 000)	(8 700)
Administrative expenses	(20 000)	(21 000)
Other expenses	(2 100)	(1 200)
Finance costs	(8 000)	(7 500)
Share of profit of associates	35 100	30 100
Profit before tax	161 667	128 000
Income tax expense	(40 417)	(32 000)
Profit for the year from continuing operations	121 250	96 000
* Loss for the year from discontinued operations	–	(30 500)
Profit for the year	121 250	65 500
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	933	3 367
*Remeasurements of defined benefit pension plans	(667)	1 333
Share of gain/(loss) on property revaluation of associates	400	(700)
Income tax relating to items that will not be reclassified	(166)	(1 000)
	500	3 000
Items that may be reclassified to profit or loss		
Exchange differences on translating foreign operations	5 334	10 667
*Available-for-sale financial assets	(24 000)	26 667
*Cash flow hedges	(667)	(4 000)
Income tax relating to items that may be reclassified	4 833	(8 334)
	(14 500)	25 000
Other comprehensive income for the year, net of tax	(14 000)	28 000
Total comprehensive income for the year	107 250	93 500

	20X7 $'000	20X6 $'000
Profit attributable to:		
Owners of the parent	97 000	52 400
Non-controlling interest	24 250	13 100
	121 250	65 500
Total comprehensive income attributable to		
Owners of the parent	85 800	74 800
Non-controlling interest	21 450	18 700
	107 250	93 500
Earnings per share (in currency units)	0.46	0.30

*Not in the *Financial Accounting and Reporting* syllabus

Companies are given the option of presenting this information in two statements as follows:

XYZ GROUP – STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7 $'000	20X6 $'000
Revenue	390 000	355 000
Cost of sales	(245 000)	(230 000)
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* Loss for the year from discontinued operations	–	(30 500)
Profit for the year	121 250	65 500
Profit attributable to:		
Owners of the parent	97 000	52 400
Non-controlling interest	24 250	13 100
	121 250	65 500

XYZ GROUP – STATEMENT OF OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7 $'000	20X6 $'000
Profit for the year	121 250	65 500
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	933	3 367
*Remeasurements of defined benefit pension plans	(667)	1 333
Share of gain on property revaluation of associates	400	(700)
Income tax relating to items that will not be reclassified	(166)	(1 000)
	500	3 000
Items that may be reclassified to profit or loss		
Exchange differences on translating foreign operations	5 334	10 667
*Available-for-sale financial assets	(24 000)	26 667
*Cash flow hedges	(667)	(4 000)
Income tax relating to items that may be reclassified	4 833	(8 334)
	(14 500)	25 000
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Total comprehensive income for the year	107 250	93 500

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Owners of the parent	85 800	74 800
Non-controlling interest	21 450	18 700
	107 250	93 500
Earnings per share (in currency units)	0.46	0.30

*Not in the Financial Accounting and Reporting syllabus

3.2 STATEMENT OF PROFIT OR LOSS

IAS 1 offers two possible formats for the statement of profit or loss section or separate statement of profit or loss – by function or by nature. Classification by function is more common. 'Function' refers to the business function to which the expense relates, whereas 'nature' considers the type of expense.

3.2.1 EXAMPLE OF SEPARATE STATEMENTS OF PROFIT OR LOSS

Worked Example: XYZ Group

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

Illustrating the classification of expenses by function:

	20X8 $'000	20X7 $'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X
Attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

Illustrating the classification of expenses by nature:

	20X8 $'000	20X7 $'000
Revenue	X	X
Other operating income	X	X
Changes in inventories of finished goods and work in progress	(X)	X
Work performed by the entity and capitalised	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation and amortisation expense	(X)	(X)
Impairment of property, plant and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X

	20X8 $'000	20X7 $'000
Attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

Note: The usual method of presentation is expenses by **function**.

3.2.2 INFORMATION PRESENTED IN THE STATEMENT OF PROFIT OR LOSS

In addition to items required by other IFRSs, IAS 1 requires that the statement of profit or loss includes the following line items:

- revenue
- finance costs
- share of profits and losses of associates and joint ventures accounted for using the equity method
- tax expense
- a single amount for the total of discontinued operations.

The following items must be disclosed as allocations of profit or loss for the period:

- profit or loss attributable to non-controlling interests; and
- profit or loss attributable to owners of the parent.

The allocated amounts must not be presented as items of income or expense. These relate to group accounts, covered later in this Study Guide.

Income and expense items can be **offset** when, and only when:

- it is permitted or required by an IFRS; or
- gains, losses and related expenses arising from the same or similar transactions and events are immaterial, in which case they can be aggregated.

3.2.3 EXCEPTIONAL ITEMS

IAS 1 requires that additional line items are disclosed in the statement of profit or loss and other comprehensive income where they are relevant to an understanding of an entity's financial performance.

IAS 1 does not allow the presentation of any items as extraordinary.

3.2.4 INFORMATION PRESENTED EITHER IN THE STATEMENT OR IN THE NOTES

An analysis of expenses must be shown either in the statement of profit or loss (as above, which is encouraged by the Standard) or by note, using a classification based on **either** the nature of the expenses **or** their function.

Nature of expense method

Expenses are not reallocated amongst various functions within the entity, but are aggregated in the statement of profit or loss **according to their nature** (e.g. purchase of materials, depreciation, wages and salaries, transport costs).

Function of expense/cost of sales method

You are likely to be more familiar with this method. Expenses are classified according to their function as part of cost of sales, distribution or administrative activities. This method often gives **more relevant information** for users, but the allocation of expenses by function requires the use of judgment and can be arbitrary. Consequently, perhaps, when this method is used, entities should disclose **additional information** on the nature of expenses, including employee benefits expense and depreciation and amortisation expense. **This is the method you should expect to see in your exam**.

Which of the above methods is chosen by an entity will depend on **historical and industry factors**, and also the **nature of the organisation**. The choice of method should fairly reflect the main elements of the entity's performance.

Under both methods an indication should be given of costs which are likely to vary (directly or indirectly) with the level of sales or production.

3.3 OTHER COMPREHENSIVE INCOME

IAS 1 requires that the section of the statement of profit or loss and other comprehensive income which shows other comprehensive income includes line items for:

- profit or loss;
- total other comprehensive income; and
- comprehensive income for the period being the total of profit or loss and other comprehensive income.

Items of other comprehensive income may be presented either:

- net of related tax effects; or
- before related tax effects with an aggregate amount of tax disclosed separately for items which will not be reclassified to profit or loss and items which may be reclassified to profit or loss.

The statement should also show the total comprehensive income for the period attributable to:

- non-controlling interests; and
- owners of the parent.

4 STATEMENT OF CHANGES IN EQUITY

LOs 3.1, 3.2

Section overview

- IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.

4.1 FORMAT

This is the format of the statement of changes in equity according to IAS 1. Total comprehensive income is reported in aggregate, and profit or loss and the individual elements of other comprehensive income are not identified. This reflects the aim of the statement to provide information about transactions between a company and its shareholders in their capacity as shareholders for example, dividends and share issues. IAS 1 requires an analysis of other comprehensive income by item to be shown either in the statement of changes in equity or in the notes to the accounts.

XYZ GROUP – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital $'000	Retained earnings $'000	Available for-sale financial assets $'000	Revaluation surplus $'000	Total $'000	Non-controlling interests $'000	Total equity $'000
Balance at 1 Jan 20X6	600 000	118 100	1 600	–	719 700	29 800	749 500
Changes in accounting policy	–	400	–	–	400	100	500
Restated balance	600 000	118 500	1 600	–	720 100	29 900	750 000
Changes in equity							
Dividends	–	(10 000)	–	–	(10 000)	–	(10 000)
Total comprehensive income for the year	–	53 200	16 000	1 600	70 800	18 700	89 500
Balance at 31 Dec 20X6	600 000	161 700	17 600	1 600	780 900	48 600	829 500
Changes in equity for 20X7							
Issue of share capital	50 000	–	–	–	50 000	–	50 000
Dividends	–	(15 000)	–	–	(15 000)	–	(15 000)

	Share capital $'000	Retained earnings $'000	Available for-sale financial assets $'000	Revaluation surplus $'000	Total $'000	Non-controlling interests $'000	Total equity $'000
Total comprehensive income for the year	–	96 600	(14 400)	800	83 000	21 450	104 450
Transfer to retained earnings	–	200	–	(200)	–	–	–
Balance at 31 Dec 20X7	650 000	243 500	3 200	2 200	898 900	70 050	968 950

Note that where there has been a change of accounting policy necessitating a retrospective restatement, (see IAS 8 in Module 1), the adjustment is disclosed for each period. So, rather than just showing an adjustment to the balance brought forward on 1 January 20X7, the balances for 20X6 are restated.

5 NOTES TO THE FINANCIAL STATEMENTS

LOs 3.1, 3.2

Section overview

- Some items need to be disclosed by way of note.

5.1 CONTENTS OF NOTES

The notes to the financial statements **amplify** the information given in the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. We have already noted above the information which the Standard allows to be shown by note rather than in the statements. To some extent, then, the contents of the notes will be determined by the level of detail shown **in the statements**.

5.2 STRUCTURE

The notes to the financial statements perform the following functions:

- provide information about the **basis on which the financial statements were prepared** and which **specific accounting policies** were chosen and applied to significant transactions/events
- disclose any information, not shown elsewhere in the financial statements, which is **required by IFRSs**
- show any additional information that is relevant to understanding which is not shown elsewhere in the financial statements.

The way the notes are presented is important. They should be given in a **systematic manner** and **cross-referenced** to the related figure(s) in the statement of financial position, statement of profit or loss and other comprehensive income or statement of cash flows.

Notes to the financial statements will amplify the information shown therein by giving the following:

- more **detailed analysis** or breakdowns of figures in the statements;
- **narrative information** explaining figures in the statements; and
- additional information.

For example, contingent liabilities and commitments.

IAS 1 suggests a **certain order** for notes to the financial statements. This will assist users when comparing the statements of different entities:

- statement of **compliance** with IFRSs;
- statement of the **measurement bases** and other accounting policies applied;

- **supporting information** for items presented in each financial statement in the same order as each line item and each financial statement is presented; and
- other disclosures, for example:
  - contingent liabilities, commitments and other financial disclosures; and
  - non-financial disclosures.

The order of specific items may have to be varied occasionally, but a systematic structure is still required.

5.3 DISCLOSURE OF ACCOUNTING POLICIES

The accounting policies section should describe the following:

- the **measurement basis** (or bases) used in preparing the financial statements; and
- the **other accounting policies** used, as required for a proper understanding of the financial statements.

The information on measurement bases used is clearly fundamental to an understanding of the financial statements. Where **more than one basis is used**, it should be stated to which assets or liabilities each basis has been applied.

Accounting policies were covered in Module 1.

5.4 OTHER DISCLOSURES

An entity must disclose in the notes:

- the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the amount per share; and
- the amount of any cumulative preference dividends not recognised.

IAS 1 ends by listing some **specific disclosures** which will always be required if they are not shown elsewhere in the financial statements:

- the domicile and legal form of the entity, its country of incorporation and the address of the registered office (or, if different, principal place of business);
- a description of the nature of the entity's operations and its principal activities; and
- the name of the parent entity and the ultimate parent entity of the group.

6 IAS 7 *STATEMENT OF CASH FLOWS*

LO 3.3

Section overview

- **Statements of cash flows** are a useful addition to the financial statements of an entity because accounting profit is not the only indicator of performance. Statements of cash flows show the sources and uses of cash and are a useful indicator of an entity's liquidity and solvency.

Profit does not always give a useful or meaningful picture of a company's performance. Readers of a company's financial statements might even be **misled by a reported profit figure**, as shown below:

- Shareholders might believe that if a company makes a profit after tax, of say, $100 000 that this is the amount it can afford to **pay as a dividend**. Unless the company has **sufficient cash** available to both stay in business and pay such a dividend, the shareholders' expectations would be wrong.
- Employees might believe that if a company makes profits, it can afford to **pay higher wages** in the following year. This opinion may not be correct: the ability to pay wages depends on the **availability of cash**.

- Survival of a company depends on its **ability to pay its debts when they fall due**. Such payments include 'profit and loss' items such as material purchases, wages, interest and taxation, but also capital payments for new non-current assets and the repayment of loans when they fall due.

From these examples, it is apparent that a company's performance and prospects depend not so much on the 'profits' earned in a period, but more realistically on liquidity or **cash flows**.

It is very important that the management of a company understand the need to control cash flows and actively monitor the company's cash position.

6.1 OBJECTIVE OF IAS 7

The aim of IAS 7 is to provide information to users of financial statements about an entity's **ability to generate cash and cash equivalents**. The statement of cash flows provides **historical** information about cash and cash equivalents, classifying cash flows between operating, investing and financing activities which readers can use to make predictions of future cash flows.

A statement of cash flows is presented as an **integral part** of an entity's financial statements. All types of entity can provide useful information about cash flows as the need for cash is universal, whatever the nature of their revenue-producing activities. **All entities are required by the Standard to produce a statement of cash flows**.

6.2 BENEFITS OF CASH FLOW INFORMATION

Statements of cash flows should be used **in conjunction** with the rest of the financial statements. Information about cash flows helps users gain further understanding of the change in net assets, of the entity's financial position (liquidity and solvency) and of the entity's ability to adapt to changing circumstances by adjusting the amount and timing of cash flows. Statements of cash flows **enhance comparability** as they are not affected by differing accounting policies used for the same type of transactions or events.

Cash flow information of a historical nature can be used as an indicator of the amount, timing and certainty of future cash flows. The relationship between profit and cash flows can be analysed as can changes in cash flows over time. All this information helps users of accounts make decisions.

6.3 DEFINITIONS

The standard gives the following definitions.

Definitions

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of non-current assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the equity capital and borrowings of the entity. *(IAS 7)*

6.4 CASH AND CASH EQUIVALENTS

The Standard expands on the definition of cash equivalents: they are not held for investment or other long-term purposes, but rather to meet short-term cash commitments. An investment maturing within three months **of acquisition is a cash equivalent.** Other investments such as equity investments (i.e. shares in other companies) are **not** cash equivalents (unless they are redeemable preference shares acquired with a very close redemption date!).

Loans and other borrowings are classified as financing activities. In some countries **bank overdrafts** are repayable on demand. In these circumstances an overdrawn balance will be included as a reduction in cash and cash equivalents. Such banking arrangements are characterised by a balance which fluctuates between overdrawn (debit) and cash at bank (credit).

Movements between different types of cash and cash equivalents are not included in cash flows. The investment of surplus cash in cash equivalents is part of cash management, not part of operating, investing or financing activities.

6.5 PRESENTATION OF A STATEMENT OF CASH FLOWS

Statements of cash flows show cash flows during the period classified as **operating, investing or financing activities**.

Classifying cash flows between different activities in this way helps users see the impact on cash and cash equivalents of each one, and their relationships with each other.

6.5.1 OPERATING ACTIVITIES

This is perhaps the key part of the statement of cash flows because it shows whether, and to what extent, companies can **generate cash from their operations**. It is these operating cash flows which must, in the end, pay for all cash outflows relating to other activities, such as the acquisition of non-current assets.

Most of the components of cash flows from operating activities will be those items which **determine the net profit or loss of the entity**, that is they relate to its main revenue-producing activities. The Standard gives the following as examples of cash flows from operating activities:

- cash receipts from the sale of goods and the rendering of services;
- cash receipts from royalties, fees, commissions and other revenue;
- cash payments to suppliers for goods and services; and
- cash payments to and on behalf of employees.

Certain items are included in the net profit or loss which are **not** operational cash flows, for example, the profit or loss on the sale of a piece of plant will be included in net profit or loss, but the cash flows will be classed as **investing**.

6.5.2 INVESTING ACTIVITIES

The cash flows classified under this heading show the extent of new investment in **assets which will generate future profit and cash flows**. The Standard gives the following examples of cash flows arising from investing activities:

- cash payments to acquire property, plant and equipment, intangibles and other non-current assets, including those relating to capitalised development costs and self-constructed property, plant and equipment;
- cash receipts from sales of property, plant and equipment, intangibles and other non-current assets;
- cash payments to acquire shares or loan capital of other entities;
- cash receipts from sales of shares or loan capital of other entities;
- cash advances and loans made to other parties; and
- cash receipts from the repayment of advances and loans made to other parties.

6.5.3 FINANCING ACTIVITIES

This section of the statement of cash flows shows the amount of cash which the entity's capital providers have claimed during the period. This is an indicator of **likely future interest and dividend payments**. The Standard gives the following examples of cash flows which might arise under these headings:

- cash proceeds from issuing shares;
- cash payments to owners to acquire or redeem the entity's shares;

- cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings; and
- cash repayments of amounts borrowed.

6.6 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

The Standard offers a choice of method for calculating operating cash flows:

- **direct method:** disclose major classes of gross cash receipts and gross cash payments.
- **indirect method**: net profit or loss is adjusted for the effects of transactions of a non-cash nature, any prepayments or accruals of past or future operating cash receipts or payments, and items of income or expense classified as investing or financing cash flows.

The **direct method** discloses information that is not available elsewhere in the financial statements, which could be of use in estimating future cash flows. The indirect method is more widely used in some countries, but in Australia the direct method is used by a large majority of listed companies.

6.6.1 USING THE DIRECT METHOD

There are different ways in which the **information about gross cash receipts and payments** can be obtained. The most obvious way is simply to extract the information from the accounting records.

A **proforma** for the direct method is given below.

	$'000	$'000
Cash flows from operating activities		
Cash receipts from customers	X	
Cash paid to suppliers and employees	(X)	
Cash generated from operations	X	
Interest paid	(X)	
Income taxes paid	(X)	
Net cash from operating activities		X

Worked Example: The direct method

Boggis Co. had the following transactions during the year:

(a) Purchases from suppliers were $19 500, of which $2550 was unpaid at the year end. Brought forward payables were $1000.

(b) Wages and salaries amounted to $10 500, of which $750 was unpaid at the year end. The accounts for the previous year showed an accrual for wages and salaries of $1500.

(c) Interest of $2100 on a long-term loan was paid in the year.

(d) Sales revenue was $33 400, including $900 receivables at the year end. Brought forward receivables were $400.

(e) Interest on cash deposits at the bank amounted to $75.

Calculate the cash flow from operating activities using the direct method.

Solution

	$	$
Cash flows from operating activities		
Cash received from customers ($400 + $33 400 – $900)	32 900	
Cash paid to suppliers ($1000 + $19 500 – $2550)	(17 950)	
Cash paid to employees ($1500 + $10 500 – $750)	(11 250)	
Interest paid	(2 100)	
Interest received	75	
Net cash flow from operating activities		1 675

6.6.2 USING THE INDIRECT METHOD

The profit or loss from operations for the period is adjusted for the following:

(a) non-cash items, for example, depreciation, provisions, profits/losses on the sales of assets

(b) changes during the period in inventories, operating receivables and payables.

A **proforma** of such a calculation is as follows:

	$
Profit before tax (statement of profit or loss)	X
Add depreciation	X
Finance expense	X
Loss/(profit) on sale of non-current assets	X/(X)
(Increase)/decrease in inventories	(X)/X
(Increase)/decrease in receivables	(X)/X
Increase/(decrease) in payables	X/(X)
Cash generated from operations	X
Interest paid	(X)
Dividends paid	(X)
Income taxes paid	(X)
Net cash flow from operating activities	X

It is important to understand why **certain items are added and others subtracted**.

Note the following points:

- Depreciation is not a cash expense, but is deducted in arriving at the profit figure in the statement of profit or loss and other comprehensive income. It makes sense, therefore, to eliminate it by adding it back.
- By the same logic, a loss on a disposal of a non-current asset (arising through underprovision of depreciation) needs to be added back and a profit deducted.
- An increase in inventories means less cash – you have spent cash on buying inventory.
- An increase in receivables means the company's customers have not paid as much, and therefore there is less cash.
- If we pay off payables, causing the figure to decrease, again, we have less cash.

6.6.3 DIRECT VERSUS INDIRECT

The direct method is encouraged where the necessary information is not too costly to obtain, but IAS 7 does not demand it. It could be argued that companies ought to monitor their cash flows carefully enough on an ongoing basis to be able to use the direct method at minimal extra cost.

6.7 INTEREST AND DIVIDENDS

Interest and dividends are disclosed separately, and classified consistently as either operating, investing or financing activities. In other words there is a choice of classification.

Generally a financial institution will classify interest paid and interest and dividends received as operating cash flows. There is, however, no consensus of opinion on the classification of such cash flows for other entities.

- Interest paid and interest and dividends received may be classified as operating cash flows on the basis that these amounts enter into the determination of profit or loss.
- Interest paid may be classified as a financing cash flow on the basis that this is the cost of obtaining finance.
- Interest and dividends received may be classified as investing cash flows on the basis that these amounts are returns on investments.

Dividends paid may be classified as:

- financing cash flows on the basis that they represent the cost of obtaining finance; or
- cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends from operating cash flows.

In this module we do not deal with the statements of cash flows of financial institutions and therefore the following approach is taken unless stated otherwise: interest paid is included as an operating cash flow, dividends paid as a financing cash flow and interest and dividends received as investing cash flows.

6.8 TAXES ON INCOME

Cash flows arising from taxes on income are **separately disclosed** and classified as cash flows from operating activities **unless** they can be specifically identified with financing and investing activities.

Taxation cash flows are often **difficult to match** to the originating underlying transaction, so usually tax cash flows are classified as arising from operating activities.

6.9 EXAMPLE OF A STATEMENT OF CASH FLOWS

In the next section we will prepare a statement of cash flows. First, look at these **examples**, adapted from the example given in the standard.

Worked Example: Direct method

STATEMENT OF CASH FLOWS (DIRECT METHOD) FOR THE YEAR ENDED 31 DECEMBER 20X7

	$m	$m
Cash flows from operating activities		
Cash receipts from customers	30 330	
Cash paid to suppliers and employees	(27 600)	
Cash generated from operations	2 730	
Interest paid	(270)	
Income taxes paid	(900)	
Net cash from operating activities		1 560
Cash flows from investing activities		
Purchase of property, plant and equipment	(900)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Dividends paid	(1 290)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		290
Cash and cash equivalents at beginning of period (note)		120
Cash and cash equivalents at end of period (note)		410

Worked Example: Indirect method

STATEMENT OF CASH FLOWS (INDIRECT METHOD) FOR THE YEAR ENDED 31 DECEMBER 20X7

	$m	$m
Cash flows from operating activities		
Profit before taxation	3 570	
Adjustments for:		
Depreciation	450	
Investment income	(500)	
Finance expense	400	
Operating profit before working capital changes	3 920	
Increase in trade and other receivables	(500)	
Decrease in inventories	1 050	
Decrease in trade payables	(1 740)	
Cash generated from operations	2 730	

	$m	$m
Interest paid	(270)	
Income taxes paid	(900)	
Net cash from operating activities		1 560
Cash flows from investing activities		
Purchase of property, plant and equipment	(900)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Dividends paid	(1 290)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		290
Cash and cash equivalents at beginning of period (note)		120
Cash and cash equivalents at end of period (note)		410

Note that in the indirect method version of the statement, the following items are treated in a way that might seem confusing, but the treatment is logical if you **think in terms of cash**:

- **Increase in inventory** is treated as **negative** (in brackets). This is because it represents a cash **outflow**; cash is being spent on inventory.
- An **increase in receivables** would be treated as **negative** for the same reasons; more receivables means less cash.
- By contrast an **increase in payables is positive** because cash is being retained and not used to settle accounts payable. Consequently, more cash remains in the business.

6.10 COMPONENTS OF CASH AND CASH EQUIVALENTS

The components of cash and cash equivalents are disclosed and a **reconciliation** presented, showing the amounts in the statement of cash flows reconciled with the equivalent items reported in the statement of financial position.

We also disclose the **accounting policy** used to decide the items included in cash and cash equivalents, in accordance with IAS 1 *Presentation of Financial Statements*.

6.10.1 CASH AND CASH EQUIVALENTS NOTE: ILLUSTRATION

Note: Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money market instruments. Cash and cash equivalents included in the statement of cash flows comprise the following statement of financial position amounts:

	20X7	20X6
	$m	$m
Cash on hand and balances with banks	40	25
Short-term investments	370	95
Cash and cash equivalents	410	120

6.11 NON-CASH TRANSACTIONS

Many investing and financing transactions do not have a direct effect on cash flows, even though they change the capital (equity) and assets of an entity. An example of a non-cash transaction would be making a bonus issue of shares.

Investing and financing transactions that do not generate or use cash or cash equivalents are **excluded** from the statement of cash flows. These transactions are **disclosed** in the notes to the financial statements.

6.12 OTHER DISCLOSURES

All entities should disclose, together with a **commentary by management**, any other information likely to be of importance, for example:

- restrictions on the use of or access to any part of cash and cash equivalents;
- the amount of undrawn borrowing facilities which are available; and
- cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity.

7 PREPARING A STATEMENT OF CASH FLOWS

LO 3.3

Section overview

- You need to be aware of the **format** of the statement as laid out in IAS 7. Setting out the format is the first step. Then follow the **step-by-step preparation procedure**.

Although the nature of the Financial Accounting and Reporting exam means that **you will not be required to produce a full statement of cash flows, you can be asked to calculate particular amounts within it** so you need to understand the underlying principles.

7.1 EXAMPLE: PREPARATION OF A STATEMENT OF CASH FLOWS (INDIRECT METHOD)

Worked Example: Colby Co. (1)

Colby Co.'s statement of profit or loss for the year ended 31 December 20X2 and statements of financial position at 31 December 20X1 and 31 December 20X2 were as follows:

COLBY CO.
STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000	$'000
Revenue		720
Raw materials consumed	70	
Employee costs	94	
Depreciation	118	
Loss on disposal of non-current asset	18	
		(300)
		420
Finance expense		(28)
Profit before tax		392
Taxation		(124)
Profit for the period		268

MODULE 3

COLBY CO.
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X2		20X1	
	$'000	$'000	$'000	$'000
Assets				
Property, plant and equipment				
Cost	1 596		1 560	
Depreciation	318		224	
		1 278		1 336
Current assets				
Inventory	24		20	
Trade receivables	76		58	
Cash and cash equivalents	48		56	
		48		134
Total assets		1 426		1 470
Equity and liabilities				
Capital and reserves				
Share capital	396		364	
Retained earnings	716		514	
		1 112		878
Non-current liabilities				
Non-current loans		200		500
Current liabilities				
Trade payables	12		6	
Taxation	102		86	
		114		92
Total equity and liabilities		1 426		1 470

During the year, the company paid $90 000 for a new piece of machinery.

Dividends paid during 20X2 totalled $66 000.

Required

Prepare a statement of cash flows for Colby Co. for the year ended 31 December 20X2 in accordance with the requirements of IAS 7, using the indirect method.

Solution

Step 1 Set out the proforma statement of cash flows with the headings required by IAS 7. It is obviously essential to know the formats very well.

Step 2 Begin with the reconciliation of profit before tax to net cash from operating activities as far as possible. When preparing the statement from statements of financial position, you will usually have to calculate such items as depreciation, profit or loss on sale of non-current assets, profit for the year and tax paid (see Step 4). Note that you may not be given the tax charge in the statement of profit or loss. You will then have to assume that the tax paid in the year is last year's year-end liability and calculate the charge as the balancing figure.

Step 3 Calculate the cash flow figures for dividends paid, purchase or sale of non-current assets, issue of shares and repayment of loans if these are not already given to you (as they may be). In order to calculate these amounts, you may find it useful to use T accounts or reconciliation workings: the opening balance in the statement of financial position will reconcile to the closing balance in the statement of financial position by way of profit or loss items and cash flows.

Step 4 If you are not given the profit figure, you will need to calculate this amount. Using opening and closing retained earnings, the taxation charge and dividends paid, you will be able to calculate profit for the year as the balancing figure to put in the profit before tax to net cash flow from operating activities section.

Step 5 You will now be able to complete the statement by correctly inserting the figures given or calculated above.

COLBY CO.
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000	$'000
Cash flows from operating activities		
Profit before tax	392	
Depreciation charges	118	
Loss on sale of property, plant and equipment	18	
Finance expense	28	
Increase in inventories	(4)	
Increase in receivables	(18)	
Increase in payables	6	
Cash generated from operations	540	
Interest paid	(28)	
Tax paid (86 + 124 – 102)	(108)	
Net cash from operating activities		404
Cash flows from investing activities		
Payments to acquire property, plant and equipment	(90)	
Proceeds from sales of property, plant and equipment (W)	12	
Net cash used in investing activities		(78)
Cash flows from financing activities		
Issue of share capital (396 – 364)	32	
Long-term loans repaid (500 – 200)	(300)	
Dividends paid	(66)	
Net cash used in financing activities		(334)
Decrease in cash and cash equivalents		(8)
Cash and cash equivalents at 1.1.X2		56
Cash and cash equivalents at 31.12.X2		48

Working: property, plant and equipment

COST

	$'000		$'000
At 1.1.X2	1 560	At 31.12.X2	1 596
Purchases	90	Disposals (balance)	54
	1 650		1 650

ACCUMULATED DEPRECIATION

	$'000		$'000
At 31.12.X2	318	At 1.1.X2	224
Depreciation on disposals (balance)	24	Charge for year	118
	342		342
Carrying amount of disposals (54 – 24)			30
Net loss reported			(18)
Proceeds from disposals			12

7.2 EXAMPLE: PREPARATION OF A STATEMENT OF CASH FLOWS (DIRECT METHOD)

Worked Example: Colby Co. (2)

If the direct method is used, the cash flows from operating activities are presented differently, showing cash received from customers and cash paid to suppliers and employees, rather than a reconciliation of profit before tax to the net cash flow from operating activities. Cash flows from investing activities

MODULE 3

and cash flows from financing activities are calculated and presented in exactly the same way as before.

We will use the financial statements of Colby Co. for the year ended 31 December 20X2 to prepare the first part of the statement of cash flows for the year ended 31 December 20X2, using the direct method.

Solution

Step 1 Set out the proforma statement of cash flows with the headings required by IAS 7.

Step 2 Calculate the figure for cash receipts from customers. Cash received from customers is sales for the year (from the statement of profit or loss), plus opening trade receivables, less closing trade receivables (from the statement of financial position).

Step 3 Calculate the figure for cash paid to suppliers and employees. First calculate the figure for purchases: raw materials consumed (from the statement of profit or loss), less opening inventories, plus closing inventories (from the statement of financial position). Then use the purchases figure to calculate the cash outflow: purchases, plus opening trade payables, less closing trade payables (from the statement of financial position). Cash paid to employees can be taken directly from the statement of profit or loss.

Where the statement of profit or loss is presented by function (the more usual method) the calculations can be slightly more complicated. Purchases include cost of sales, plus distribution costs and administrative expenses. If cost of sales and other expenses include depreciation, this must be excluded, as depreciation is not a cash flow. As before, to calculate these amounts, you may find it useful to use T accounts or reconciliation workings: the opening balance in the statement of financial position will reconcile to the closing balance in the statement of financial position by way of the profit or loss items and cash flows.

Step 4 You can now complete the statement by correctly inserting the figures given or calculated above. Notice that the figures for cash generated from operations, interest paid and tax paid are exactly the same as under the indirect method.

COLBY CO.
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000	$'000
Cash flows from operating activities		
Cash receipts from customers	702	
Cash paid to suppliers and employees (68 + 94)	(162)	
Cash generated from operations	540	
Interest paid	(28)	
Tax paid (86 + 124 – 102)	(108)	
Net cash from operating activities		404

Workings

CASH RECEIPTS FROM CUSTOMERS

	$'000		$'000
At 1.1.X2	58	At 31.12.X2	76
Sales	720	Cash received (balance)	702
	778		778

CASH PAID TO SUPPLIERS

	$'000		$'000
At 31.12.X2	12	At 1.1.X2	6
Cash paid (balance)	68	Purchases (70 – 20 + 24)	74
	80		80

Question 1: Statement of cash flows

Set out below are the financial statements of Shabnum Co. You are the financial controller, faced with the task of implementing IAS 7 *Statement of Cash Flows*.

SHABNUM CO.

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000
Revenue	2 553
Cost of sales	(1 814)
Gross profit	739
Distribution costs	(125)
Administrative expenses	(264)
	350
Interest received	25
Finance costs	(75)
Profit before taxation	300
Taxation	(140)
Profit for the period	160
Other comprehensive income:	
Surplus on revaluation of property	9
Total comprehensive income for the period	169

SHABNUM CO.
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X2 $'000	20X1 $'000
Assets		
Non-current assets		
Property, plant and equipment	380	305
Intangible assets	250	200
Investments	–	25
Current assets		
Inventories	150	102
Receivables	390	315
Short-term investments	50	–
Cash balances	2	1
Total assets	1 222	948
Equity and liabilities		
Equity		
Share capital	360	300
Revaluation reserve	100	91
Retained earnings	260	180
Non-current liabilities		
Loan	170	50
Current liabilities		
Trade payables	127	119
Bank overdraft	85	98
Taxation	120	110
Total equity and liabilities	1 222	948

The following information is available:

(a) Proceeds from the sale of non-current asset investments amounted to $30 000.

(b) Fixtures and fittings, with an original cost of $85 000 and a carrying amount of $45 000, were sold for $32 000 during the year.

(c) The following information relates to property, plant and equipment:

	31.12.20X2 $'000	31.12.20X1 $'000
Cost	720	595
Accumulated depreciation	340	290
Carrying amount	380	305

(d) 50 000 ordinary shares were issued during the year.

(e) Dividends totalling $80 000 were paid during the year.

(f) Shabnum Co. classifies interest paid as an operating cash flow, dividends paid as a financing cash flow and interest and dividends received as investing cash flows.

Required

Prepare a statement of cash flows for the year to 31 December 20X2 in accordance with the requirements of IAS 7, using the indirect method.

(The answer is at the end of the module.)

7.3 CALCULATING CASH FLOWS: THE BASIC PRINCIPLE

In the examples above, we used the opening and closing statements of financial position and the statement of profit or loss and other comprehensive income for the year to arrive at a balancing figure: the cash flow for the year. **We can use the same technique to find any cash flow amount**.

We can also use this relationship to calculate figures in the statement of profit or loss and other comprehensive income or statement of financial position using the statement of cash flows and other information.

Worked Example: retained earnings and dividends paid

In the example above, Colby Co., you were given the amount of dividends paid during the year. It would also have been possible to calculate dividends paid from the information in the financial statements.

The statement of financial position shows opening retained earnings and closing retained earnings. The statement of profit or loss shows the profit before tax for the year. We can use these figures to reconstruct the movements in retained earnings. Closing retained earnings are less than opening retained earnings plus profit for the year. The difference is dividends paid:

	$'000
Opening retained earnings (statement of financial position)	514
Add: Profit before tax for the year (statement of profit or loss)	268
Less: dividends paid (balancing figure)	**(66)**
Closing retained earnings (statement of financial position)	716

Question 2: Opening balance

During the year ended 31 December 20X6, Tin Ltd had cash receipts from customers of $220 000 and sales revenue of $250 000. Irrecoverable debts for the year were $ 10 000. At 31 December 20X6, trade receivables were $70 000.

Required

What amount was shown in the statement of financial position for trade receivables at 1 January 20X6?

A $30 000

B $40 000

C $50 000

D $90 000

(The answer is at the end of the module.)

Question 3: Cash paid to suppliers

The following information has been extracted from the statement of financial position of Iron Ltd.

	20X4 $'000	20X3 $'000
Inventories	450	390
Trade payables and accruals	220	130

Cost of sales for the year ended 31 December 20X4 was $575 000. Operating expenses for the year were $120 000. Depreciation for the year (included in cost of sales) was $40 000.

Required

What was cash paid to suppliers in respect of purchases and expenses for the year ended 31 December 20X4?

(The answer is at the end of the module.)

Question 4: Cash flow accounting

Can you think of some possible disadvantages of cash flow accounting?

(The answer is at the end of the module.)

7.4 THE ADVANTAGES OF CASH FLOW ACCOUNTING

The advantages of cash flow accounting are as follows:

- Survival in business depends on the **ability to generate** cash. Cash flow accounting directs attention towards this critical issue.
- Cash flow is **less subjective** than 'profit' which is dependent on accounting conventions and concepts.
- **Creditors** (long and short-term) are more interested in an entity's ability to repay them than in its profitability. Whereas 'profits' might indicate that cash is likely to be available, cash flow accounting is more direct with its message.
- Cash flow reporting provides a better means of **comparing the results** of different companies than traditional profit reporting.
- Cash flow reporting **satisfies the needs of all users** better.
  - For **management**, it provides the sort of information on which decisions should be taken: (in management accounting, 'relevant costs' to a decision are future cash flows); traditional profit accounting does not help with decision-making.
  - For **shareholders and auditors**, cash flow accounting can provide a satisfactory basis for stewardship accounting.
  - As described previously, the information needs of **creditors and employees** will be better served by cash flow accounting.
- Cash flow forecasts are **easier to prepare**, as well as more useful, than profit forecasts.
- Cash flow reporting can in some respects be **audited more easily** than accounts based on the accruals concept.
- The accruals concept is confusing, and cash flows are **more easily understood**.

7.5 CRITICISMS OF IAS 7

The inclusion of **cash equivalents** has been criticised because it does not reflect the way in which businesses are managed: in particular, the requirement that to be a cash equivalent an investment has to be within three months of maturity is considered **unrealistic**.

8 INTERNAL CONTROL, AND THE ROLE OF THE INTERNAL AND EXTERNAL AUDITORS

Section overview

- An entity will implement controls to ensure that financial statements and underlying accounting records are complete and accurate. Internal auditors will have a role in this. The external audit is a type of assurance engagement carried out by an external auditor to provide an independent opinion on the truth and fairness of an entity's financial statements.

8.1 INTERNAL CONTROL

Definition

Internal control is the process designed, implemented and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

In other words, a system of internal control helps management:

- report reliably
- operate efficiently
- comply with legal requirements
- keep its assets secure from theft or damage.

Internal control has five elements:

1. the control environment
2. the entity's risk assessment process
3. the information system relevant to financial reporting
4. control activities
5. monitoring of controls.

Let's look at two of these in more detail – the information system relevant to financial reporting and control activities as these relate directly to the financial statements.

Definition

The **information system relevant to financial reporting** is a component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity transactions and to maintain accountability for the related assets, liabilities and equity.

The information system relevant to financial reporting includes the following:

- the classes of transactions in the entity's operations that are significant to the financial statements
- the procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected, transferred to the nominal ledger and reported in the financial statements
- the related accounting records, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions
- how the information system captures events and conditions, other than transactions, that are significant to the financial statements

- the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures
- controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

Definition

Control activities are those policies and procedures that help ensure that management directives are carried out.

Control activities include those activities designed to **prevent** or to **detect** and **correct errors**. Examples include activities relating to authorisation, performance reviews, information processing, physical controls and segregation of duties.

In terms of the financial statements, these control activities are particularly relevant:

EXAMPLES OF CONTROL ACTIVITIES

Approval and control of documents	Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers.
Controls over computerised applications	Examples include batch and hash totals.
Checking the arithmetical accuracy of records	For example, checking to see if individual invoices have been added up correctly.
Maintaining and reviewing control accounts and trial balances	Control accounts bring together transactions in individual ledgers. Trial balances bring together unusual transactions for the organisation as a whole. Preparing these can highlight unusual transactions or accounts.
Reconciliations	Reconciliations involve comparison of a specific balance in the accounting records with what another source says the balance should be, for example, a bank reconciliation. Differences between the two figures should only be reconciling items.
Comparing the results of cash, security and inventory counts with accounting records	For example, in a physical count of petty cash, the balance shown in the cash book should be the same as the amount held.
Comparing internal data with external sources of information	For example, comparing records of goods despatched to customers with customers' acknowledgement of goods that have been received.
Limiting physical access to assets and records	Only authorised personnel should have access to certain assets (particularly valuable or portable ones). For example, ensuring that the inventory store is only open when store personnel are there and is otherwise locked.

At a more senior level, management can also make use of analytical procedures to carry out a sense check on the completeness and accuracy of the financial statements.

Definition

Analytical procedures are evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data.

Analytical procedures will include comparison of financial statements with prior year financial statements and with budgets to allow for a high level check on the reasonableness and consistency of the financial statements.

8.1.1 IAS 8 *ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS*

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* deals with the accounting for changes in accounting policies and estimates and also considers errors. We will briefly look at the situation where errors are discovered during a current period which **relate to a prior period**. These may arise through:

- mathematical mistakes;
- mistakes in the application of accounting policies;
- misinterpretation of facts;
- oversights; or
- fraud.

Definition

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Most of the time these errors can be **corrected through net profit or loss for the current period**. Where they are material prior period errors, however, this is not appropriate. The standard considers two possible treatments.

Prior period errors: correct retrospectively. There is no longer any allowed alternative treatment.

This involves:

- either restating the comparative amounts for the prior period(s) in which the error occurred; or
- when the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period, so that the financial statements are presented **as if the error had never occurred**.

Only where it is **impracticable** to determine the cumulative effect of an error on prior periods can an entity correct an error **prospectively**.

Various **disclosures** are required:

(a) **nature** of the prior period error

(b) for each prior period, to the extent practicable, the **amount** of the correction:
   (i) for each financial statement line item affected
   (ii) if IAS 33 applies, for basic and diluted earnings per share

(c) the amount of the correction at the **beginning of the earliest prior period** presented

(d) if **retrospective restatement is impracticable** for a particular prior period, the **circumstances** that led to the existence of that condition and a description of how and from when the error has been corrected. Subsequent periods need not repeat these disclosures.

Question 5: Error

During 20X7 Global discovered that certain items had been included in inventory at 31 December 20X6, valued at $4.2m, which had in fact been sold before the year end. The following figures for 20X6 (as reported) and 20X7 (draft) are available.

	20X6 $'000	20X7 (draft) $'000
Sales	47 400	67 200
Cost of goods sold	(34 570)	(55 800)
Profit before taxation	12 830	11 400
Income taxes	(3 880)	(3 400)
Profit for the period	8 950	8 000

Retained earnings at 1 January 20X6 were $13m. The cost of goods sold for 20X7 includes the $4.2m error in opening inventory. The income tax rate was 30 per cent for 20X6 and 20X7. No dividends have been declared or paid.

Required

Show the statement of profit or loss for 20X7, with the 20X6 comparative, and retained earnings.

(The answer is at the end of the module.)

8.2 THE ROLE OF THE INTERNAL AUDITOR

A key part of the internal control system discussed above will be the internal audit function. The internal audit function is generally a feature of large companies. It is a function, provided either by employees of the entity or sourced from an external organisation to assist management in **achieving corporate objectives.**

Definition

Internal audit function is a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

The internal audit function can assist the board in other ways as well:

- by, in effect, acting as auditors for board reports not audited by the external auditors
- by being the experts in fields such as auditing and accounting standards in the company and assisting in implementation of new standards
- by liaising with external auditors, particularly where external auditors can use internal audit work and reduce the time and therefore cost of the external audit. In addition, internal audit can check that external auditors are reporting back to the board everything they are required to under auditing standards.

Internal auditors may carry out a range of activities, from fraud investigations to value for money audits. In terms of the financial statements, their role may include financial audit which involves reviewing all the available evidence (usually the company's records) to substantiate information in management and financial reporting.

We mentioned external auditors here and this will be discussed in more detail below.

8.3 WHY ARE EXTERNAL AUDITS REQUIRED?

Directors of all companies are usually **required to produce financial statements** annually which give a **true and fair view** of the affairs of the company and its profit or loss for the period. They are also **encouraged** to **communicate with shareholders** on matters relating to **directors' pay** and **benefits** (this is required by law in the case of public limited companies), **going concern** and **management of risks**.

But how will the shareholders know whether the directors' communications are **accurate**, or present a **fair picture?** This is where the external auditor comes in. External auditors provide an impartial, independent opinion on a set of financial statements and make an assessment on the **truth and fairness** of that set of financial statements.

The purpose of an external audit is to enable auditors to **give an opinion** on the financial statements. While an audit might produce by-products, such as advice to the directors on how to run the business, its objective is **solely to report to the shareholders**.

8.4 STATUTORY AND NON-STATUTORY EXTERNAL AUDITS

In many countries, external audits are required under **national statute** for many undertakings, including limited liability companies. Other organisations and entities requiring a statutory audit may include charities, investment businesses and trade unions. In the UK for example, under registered companies' legislation (currently the Companies Act 2006), most companies are required to have an audit.

The statutory audit can bring various advantages to the company and shareholders. The key benefit to shareholders is the impartial view provided by the auditors. However, the company also benefits from professional accountants reviewing the accounts and system as part of the audit. Advantages might include recommendations being made in relation to accounting and control systems and the possibility that auditors might detect fraud and error.

Non-statutory audits are performed by independent auditors because the company's owners, proprietors, members, trustees, professional and governing bodies or other interested parties want them, rather than because the law requires them. In consequence, **auditing may extend** to every type of undertaking which produces accounts, including clubs, charities (some of these may require statutory audits as well), sole traders and partnerships. Some of these organisations do not operate for profit, and this has a specific impact on the nature of their audit.

8.5 THE NATURE AND DEVELOPMENT OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS

The accounting and auditing professions have been under the public spotlight for many years now and, as a result of certain events, many changes have occurred in relation to audit and assurance engagements.

As a result of the stock market bubble of the late 1990s and speculation over the future of 'dotcom' companies, many countries experienced huge **corporate financial scandals and frauds**. The bubble burst in 2000, followed by a revelation that senior management at **Enron**, a US energy company, had been deceiving investors by fraudulently overstating profitability. Its auditor, **Arthur Andersen**, was shown to have lacked objectivity in evaluating Enron's accounting methods. This led to the demise of Arthur Andersen in 2002.

Other companies that were also involved in corporate frauds included WorldCom, Parmalat, Cable & Wireless and Xerox, to name but a few. The subsequent fallout of these frauds was a lack of confidence in the way companies were run and audited. In the US, this resulted in the **Sarbanes-Oxley Act 2002** which has not only radically changed the **regulation** of the accounting profession in the US but also influenced such issues worldwide.

In September 2008 Lehman Brothers, a global financial services firm, filed for bankruptcy in the US triggering a severe worldwide financial crisis. Lehman had expanded aggressively into property-related investments, including so-called sub-prime mortgages (loans to people on low incomes or with poor credit histories). In subsequent reports it was claimed that Lehman Brothers covered up the extent of its irrecoverable debts using an accounting manoeuvre known as 'Repo 105', which involves loaning 'bad' assets to other firms in exchange for short-term financing. Lehman's auditors had issued a clean audit report on the accounts to 30 November 2007 and the Accountancy and Actuarial Discipline Board (AADB), an independent investigative and disciplinary body in the UK, commenced an investigation in 2010 into the conduct of the auditors of Lehman Brothers International Europe.

Following the collapse of Lehman Brothers, other banks failed worldwide and many needed government support to continue. There was a knock-on effect in the wider economy in many countries in 2008 and 2009, with many businesses struggling or failing altogether.

In light of this global financial crisis, regulators have again been considering the effectiveness of the audit and the auditor's role in helping to prevent, or at least provide warning of, corporate and financial institution collapses in the future.

The above events illustrate how important it is to companies and their shareholders that auditing and other assurance engagements are carried out effectively.

8.6 THE AUDITOR'S REPORT

The end-product of the external audit is the **auditor's report**. This sets out the auditor's opinion on the truth and fairness of the entity's financial statements.

The audit opinion on whether the financial statements are true and fair is not an opinion of absolute correctness. 'True' and 'fair' are not defined in law or audit guidance, but the following definitions are generally accepted.

Definition

True: Information is factual and conforms with reality. In addition, the information conforms with required standards and law. The financial statements have been correctly extracted from the books and records.

Fair: Information is free from discrimination and bias and in compliance with expected standards and rules. The financial statements should reflect the commercial substance of the company's underlying transactions.

We looked at an example of an unmodified (i.e. the financial statements are true and fair) auditor's report in Module 2. You do not need to know the detail of this – it is simply included in this Study Guide for illustration.

Auditors' reports with **modified** opinions may arise because of a number of different reasons but these are outside the scope of this syllabus.

The auditor's report refers to the fact that the auditor's objective is to obtain 'reasonable assurance' as to whether the financial statements are free from material misstatement. This is because the auditor cannot check everything and therefore can only provide 'reasonable', not 'absolute', assurance.

Definition

An audit gives the reader **reasonable assurance** on the truth and fairness of the financial statements, which is a high, but not absolute, level of assurance. The auditor's report does not guarantee that the financial statements are correct, but that they are true and fair within a reasonable margin of error.

KEY MODULE POINTS

- IAS 1 covers the form and content of financial statements. The main components are:
  - statement of financial position;
  - statement of profit or loss and other comprehensive income;
  - statement of changes in equity;
  - statement of cash flows; and
  - notes to the financial statements.
- IAS 1 suggests a format for the statement of financial position. Certain items are specified for **disclosure in the financial statements and notes to the accounts**.
- Assets and liabilities should be analysed between current and non-current, and there are rules determining the appropriate category.
- IAS 1 requires total comprehensive income in a period to be shown either in a statement of profit or loss and other comprehensive income or in a separate statement reporting other comprehensive income and total comprehensive income.
- Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. It comprises all components of profit or loss and of other comprehensive income.
- Other comprehensive income refers to items which other standards do not allow or permit to be recognised in profit or loss.
- IAS 1 offers two possible formats for the profit or loss section of the statement of profit or loss and other comprehensive income or separate statement of profit or loss – by function or by nature. Classification by function is more common.
- IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position as a result of transactions with shareholders in their capacity as shareholders. It also shows profit or loss and other comprehensive income.
- Some items need to be disclosed by way of note, for example, accounting policies.
- A statement of cash flows concentrates on the sources and uses of cash and is a useful indicator of a company's liquidity and solvency.
- A company cannot survive without cash and therefore cash flow is at least as important as profits. It is also factual and not affected by accounting policies or estimates.
- The statement of cash flows provides **historical** information about cash and cash equivalents, classifying cash flows between operating, investing and financing activities.
- Cash comprises cash in hand and cash equivalents, such as demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
- Cash flows from operating activities include:
  - cash receipts from the sale of goods and the rendering of services
  - cash receipts from royalties, fees, commissions and other revenue
  - cash payments to suppliers for goods and services
  - cash payments to and on behalf of employees.
- The direct or indirect method may be used to report cash flows from operating activities.
- Cash flows arising from investing activities include:
  - cash payments to acquire property, plant and equipment, intangibles and other non-current assets, including those relating to capitalised development costs and self-constructed property, plant and equipment

  - cash receipts from sales of property, plant and equipment, intangibles and other non-current assets
  - cash payments to acquire shares or loan capital of other entities
  - cash receipts from sales of shares or loan capital of other entities
  - cash advances and loans made to other parties
  - cash receipts from the repayment of advances and loans made to other parties.
- Cash flows from financing activities include:
  - cash proceeds from issuing shares
  - cash payments to owners to acquire or redeem the entity's shares
  - cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings
  - cash repayments of amounts borrowed.
- Interest and dividend cash flows may be classified as either operating, investing or financing cash flows, however a consistent approach must be taken.
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides guidance on the accounting treatment of prior period errors.
- The role of the external auditor is to provide an independent opinion on whether an entity's financial statements are true and fair.

QUICK REVISION QUESTIONS

1 Which of the following are examples of current assets?

I. prepayments
II. cash equivalents
III. manufacturing licences
IV. income received in advance
V. property, plant and equipment

A IV only
B I and II only
C I, II and III only
D I, II, III, IV and V

2 Which of the following must be disclosed in the statement of profit or loss and other comprehensive income?

I. tax expense
II. analysis of expenses
III. net profit or loss for the period

A I and II only
B I and III only
C II and III only
D I, II and III

3 In the current financial year, Natamo has raised a loan for $3 million. The loan is repayable in 10 equal half yearly instalments. The first instalment is due 6 months after the loan was raised.
The loan will be reported in Natamo's next financial statements

A as capital.
B as a current liability.
C as a non-current liability.
D as both a current and a non-current liability.

4 When reporting profit for a period, companies are required to ensure that income and expenses are correctly classified.
Which one of the following expenses will not be included in the calculation of profit before tax?

A interest payable
B reorganisation costs
C depreciation expense
D profits attributable to non-controlling interests

5 The draft statement of profit or loss and other comprehensive income of Thermin for the year ended 30 November 20X4 shows a profit before tax of $325 800. This includes:

1. a restructuring charge of $85 000; and
2. an adjustment of $42 000 to reduce the value of opening inventory. An error at the previous year end had led to the inventory being over-valued.

What is the correct profit before tax for the year ended 30 November 20X4?

A $283 800
B $325 800
C $367 800
D $452 800

6 In the last financial year Cuchabee issued an invoice for $28 900 for the sale of inventory which had cost $27 600.

What was the effect of this transaction on the company's assets, liabilities and capital and reserves?

	Assets	Liabilities	Capital and reserves
A	increased	reduced	increased
B	increased	unchanged	increased
C	reduced	unchanged	reduced
D	unchanged	reduced	increased

7 Which one of the following is reported as other comprehensive income?

A a dividend
B the proceeds of a share issue
C the profit on sale of a property
D a surplus on revaluation of a property

8 Which of the following items could appear in a company's statement of cash flows?

I. dividends received
II. proposed dividend
III. proceeds from issue of shares
IV. irrecoverable debts written-off
V. surplus on revaluation of non-current assets

A I and III only
B II and IV only
C I, II and IV only
D I, III and V only

9 Part of the process of preparing a company's statement of cash flows is the calculation of cash flow from operating activities.

Which of the following statements about that calculation (using the indirect method) are correct?

I. Increase in payables should be added to operating profits.
II. Increase in inventory should be deducted from operating profits.
III. Depreciation charges should be added to profit before tax.
IV. Loss on sale of operating non-current assets should be deducted from profit before tax.

A I, II and III only
B I, II and IV only
C I, III and IV only
D II, III and IV only

10 In the course of preparing a company's statement of cash flows, the following figures are to be included in the calculation of net cash from operating activities.

	$
Depreciation charges	980 000
Profit on sale of non-current assets	40 000
Increase in inventories	130 000
Decrease in receivables	100 000
Increase in payables	80 000

What will the net effect of these items be in the statement of cash flows?

		$
A	addition to operating profit	890 000
B	subtraction from operating profit	890 000
C	addition to operating profit	990 000
D	addition to operating profit	1 070 000

11 Part of a company's draft statement of operating cash flows is shown below:

	$'000
Operating profit	8 640
Depreciation charges	(2 160)
Proceeds from sale of non-current assets	360
Increase in inventory	(330)
Increase in accounts payable	440

The following criticisms of the above extract have been made:

I. Increase in inventory should have been added, not deducted.
II. Depreciation charges should have been added, not deducted.
III. Increase in accounts payable should have been deducted, not added.
IV. Proceeds from sale of non-current assets should not appear in this part of the statement of cash flows.

Which of these criticisms are valid?

A I and III only
B I and IV only
C II and III only
D II and IV only

12 A company has the following information about property, plant and equipment:

	20X7 $'000	20X6 $'000
Cost	750	600
Accumulated depreciation	250	150
Carrying amount	500	450

Plant with a carrying amount of $75 000 (original cost $90 000) was sold for $30 000 during the year.

What is the cash flow from investing activities for the year?

A $95 000 inflow
B $210 000 inflow
C $95 000 outflow
D $210 000 outflow

13 A company provides the following extract from its statement of financial position:

	20X7 $'000	20X6 $'000
Share capital	2 500	1 000
Loans	750	1 000

What is the cash flow from financing activities for the year?

A $1 250 000 inflow
B $1 750 000 inflow
C $1 250 000 outflow
D $1 750 000 outflow

14 In the year ended 31 December 20X4 a company sold some plant which had cost $100 000 for $20 000. At the time of sale the carrying amount of the plant was $18 000.

Which of the following correctly states the treatment of the transaction in the company's statement of cash flows?

	Proceeds of sale	Profit on sale
A	cash inflow under financing activities	added to profit in calculating cash flow from operating activities
B	cash inflow under investing activities	added to profit in calculating cash flow from operating activities
C	cash inflow under financing activities	deducted from profit in calculating cash flow from operating activities
D	cash inflow under investing activities	deducted from profit in calculating cash flow from operating activities

15 A company's statements of financial position at 31 December 20X4 and 20X5 included the following items:

	Statements of financial position at	
	31.12.X5	31.12.X4
	$'000	$'000
Taxation payable	840	760
Retained earnings	1 660	1 470

The company paid no interest or interim dividends during these years, and the tax liability of $760 000 in the 20X4 statement of financial position was the amount paid in 20X5. Using this information, what is the company's operating profit for 20X5 for inclusion in its statement of cash flows?

A $190 000
B $950 000
C $1 030 000
D $1 660 000

16 The statements of financial position of R, a limited liability company, at 31 December 20X3 and 20X4 included these figures:

	31 December	
	20X3	20X4
Property, plant and equipment:	$m	$m
Cost	40	50
Accumulated depreciation	(10)	(14)
	30	36

The statement of profit or loss and other comprehensive income for the year ended 31 December 20X4 showed the following figures:

Depreciation charge for year	$6m
Loss on sale of property, plant and equipment	$1m

The company purchased new property, plant and equipment costing $16m during the year.

What figure should appear in the company's statement of cash flows for 20X4 for receipts from the sale of property, plant and equipment?

A $3 m
B $4 m
C $5 m
D The figure cannot be calculated from the information provided.

17 At 1 October 20X4, BK had the following balance:

Accrued interest payable	$12 000 credit

During the year ended 30 September 20X5, BK charged interest payable of $41 000 to its statement of profit or loss and other comprehensive income. The closing balance on accrued interest payable account at 30 September 20X5 was $15 000 credit.

How much interest paid should BK show in its statement of cash flows for the year ended 30 September 20X5?

A $38 000
B $41 000
C $44 000
D $53 000

18 What is the role of the external auditor in the audit of a set of financial statements?

A to provide management with a set of financial statements
B to provide absolute assurance that the financial statements are correct
C to provide recommendations to the entity's management on improving controls
D to provide reasonable assurance on the truth and fairness of the financial statements

ANSWERS TO QUICK REVISION QUESTIONS

1 B I and II only. III and V are non-current assets. Income received in advance is termed deferred income and recognised as a current (and/or non-current) liability.

2 B I and III only. II may be shown in the notes.

3 D The amount due within 12 months of the reporting date should be disclosed as a current liability and the remainder as non-current.

4 D Non-controlling interests are apportioned their share of profits after tax; they do not feature within the calculation of profit before tax.

5 B Both items have been dealt with correctly. The restructuring charge, although exceptional in nature, should be charged against this year's profits. Although the adjustment to opening inventory is a prior period adjustment (it corrects an error) it also affects the profit for the current year because it affects cost of sales for both years. Cost of sales for the prior period is increased and profit reduced; cost of sales for the current year is reduced and profit increased.

6 B Assets will increase as the receivable value is higher than the carrying amount of the inventory. There is no effect on liabilities. Capital and reserves will increase as the inventory was sold for a profit.

7 D A and B are transactions with shareholders and so reported in the statement of changes in equity; C is realised income and so reported within profit or loss in the statement of profit or loss and other comprehensive income.

8 A Only the proceeds of a share issue and dividends received involve the movement of cash.

9 A Loss on sale of non-current assets should be added back to profit before tax.

10 C

	$
Add: depreciation charge	980 000
Less: profit on sale of assets	(40 000)
Less: increase in inventories	(130 000)
Add: decrease in receivables	100 000
Add: increase in payables	80 000
Addition to operating profit	990 000

11 D Depreciation should be added back as it not a cash flow and proceeds from sale of non-current assets appears under 'investing' cash flows.

12 D

PROPERTY, PLANT AND EQUIPMENT

	$'000		$'000
Opening balance	600	Disposals	90
Purchases (balancing figure)	240	Closing balance	750
	840		840

Purchase of property, plant and equipment	240 000
Proceeds from sale of property, plant and equipment	(30 000)
Net cash outflow	210 000

13 A

	$'000
Issue of share capital (2500 – 1000)	1 500
Repayment of loans (1000 – 750)	(250)
Net cash inflow	1 250

14 D Profit on disposal will be included in profit, so should be deducted.

MODULE 3

15 C

	$'000
Retained earnings 31.12.X5	1 660
Retained earnings 31.12.X4	1 470
∴ Post tax profit for 20X5	190
Add back tax charge*	840
	1 030

* **Note:** This is the current liability at 31.12.X5, just as the 20X4 charge is the current liability at 31.12.X4.

16 A

PROPERTY, PLANT AND EQUIPMENT: COST

	$m		$m
Opening balance	40	Transfer disposal (balancing figure)	6
Cash – additions	16	Closing balance	50
	56		56

PROPERTY, PLANT AND EQUIPMENT: ACCUMULATED DEPRECIATION

	$m		$m
		Opening balance	10
Transfer disposal (balancing figure)	2	Profit or loss	6
Closing balance	14		
	16		16

PROPERTY, PLANT AND EQUIPMENT: DISPOSAL

	$m		$m
Transfer cost	6	Transfer depreciation	2
		Loss on sale	1
		Proceeds of sale (balancing figure)	3
	6		6

17 A Interest paid = $38 000

INTEREST PAYABLE

	$		$
Cash paid (bal fig)	38 000	Opening balance	12 000
Closing balance	15 000	Profit or loss	41 000
	53 000		53 000

18 D

ANSWERS TO MODULE QUESTIONS

1 SHABNUM CO.

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000	$'000
Cash flows from operating activities		
Profit before tax	300	
Depreciation charge (W1)	90	
Interest expense	50	
Loss on sale of property, plant and equipment (45 – 32)	13	
Profit on sale of non-current asset investments	(5)	
(Increase)/decrease in inventories	(48)	
(Increase)/decrease in receivables	(75)	
Increase/(decrease) in payables	8	
Cash generated from operating activities	333	
Interest paid	(75)	
Tax paid (110 + 140 – 120)	(130)	
Net cash from operating activities		128
Cash flows from investing activities		
Payments to acquire property, plant and equipment (W2)	(201)	
Payments to acquire intangible non-current assets	(50)	
Receipts from sales of property, plant and equipment	32	
Receipts from sale of non-current asset investments	30	
Interest received	25	
Net cash used in investing activities		(164)
Cash flows from financing activities		
Proceeds from issue of share capital	60	
Proceeds from long-term borrowings	120	
Dividends paid	(80)	
Net cash from financing activities		100
Increase in cash and cash equivalents		64
Cash and cash equivalents at 1.1.X2 (note)		(97)
Cash and cash equivalents at 31.12.X2 (note)		(33)

NOTES TO THE STATEMENT OF CASH FLOWS

Note: Analysis of the balances of cash and cash equivalents as shown in the statement of financial position.

	20X2 $'000	20X1 $'000
Cash in hand	2	1
Short-term investments	50	–
Bank overdraft	(85)	(98)
	(33)	(97)

Workings

1 *Depreciation charge*

	$'000	$'000
Accumulated depreciation at 31 December 20X2		340
Accumulated depreciation at 31 December 20X1	290	
Depreciation on assets sold (85 – 45)	(40)	
		(250)
Charge for the year		90

MODULE 3

2 *Purchase of property, plant and equipment*

PROPERTY, PLANT AND EQUIPMENT

	$'000		$'000
1.1.X2 Balance b/d	595	Disposals	85
Revaluation (OCI)	9		
Purchases (bal fig)	201	31.12.X2 Balance c/d	720
	805		805

Note: In this answer, dividends paid have been presented under financing activities, but it would also be acceptable to include them under operating activities and/or investing activities.

2 The answer is C.

TRADE RECEIVABLES

	$'000		$'000
At 1.1.X6 (balance)	50	Cash received	220
		Irrecoverable debts	10
Sales	250	At 31.12.X6	70
	300		300

3 The answer is $625 000.

TRADE PAYABLES AND ACCRUALS

	$'000		$'000
At 31.12.X4	220	At 1.1.X4	130
Cash paid (balance)	625	Purchases and expenses (W)	715
	845		845

Purchases:

	$'000
Cost of sales:	575
Less: depreciation	(40)
	535
Less: opening inventories	(390)
Add: closing inventories	450
Purchases	595
Operating expenses	120
Purchases and expenses	715

4 The main disadvantages of cash flow accounting are essentially the advantages of accruals accounting (proper matching of related items). There is also the practical problem that few businesses keep historical cash flow information in the form needed to prepare a historical statement of cash flows and so extra record-keeping is likely to be necessary.

A problem common to all financial statements is that cash flow information is historic, however users are more interested in forward looking information. A further drawback is the possibility of manipulation of cash flows. For example, a business may delay making large payments to suppliers until after the end of the accounting period.

5 STATEMENT OF PROFIT OR LOSS

	20X6 $'000	20X7 $'000
Sales	47 400	67 200
Cost of goods sold (W1)	(38 770)	(51 600)
Profit before tax	8 630	15 600
Income tax (W2)	(2 620)	(4 660)
Profit for the year	6 010	10 940

RETAINED EARNINGS

	20X6	20X7
Opening retained earnings	$'000	$'000
As previously reported (13 000 + 8950)	13 000	21 950
Correction of prior period error (4200 – 1260)	–	(2 940)
As restated	13 000	19 010
Profit for the year	6 010	10 940
Closing retained earnings	19 010	29 950

Workings

1 *Cost of goods sold*

	20X6	20X7
	$'000	$'000
As stated in question	34 570	55 800
Inventory adjustment	4 200	(4 200)
	38 770	51 600

2 *Income tax*

	20X6	20X7
	$'000	$'000
As stated in question	3 880	3 400
Inventory adjustment (4200 × 30%)	(1 260)	1 260
	2 620	4 660

MODULE 4 APPLICATION OF SPECIFIC ACCOUNTING STANDARDS

Learning objectives	Reference
Calculate the carrying amounts of different classes of intangible assets and prepare the relevant journal entries	LO4.1
Interpret contracts to determine the amount and timing of revenue to be recognised in the financial statements and reconcile the differences between ledgers if necessary	LO4.2
Calculate current and deferred income tax and prepare the relevant journal entries to record the tax effect in the financial statements	LO4.3
Calculate and account for foreign currency transactions at transaction date and subsequent dates	LO4.4
Translate financial statements from a functional currency to a presentation currency	LO4.5

Topic list

1 IAS 38 *Intangible Assets*
2 Research and development costs
3 Impairment of individual assets
4 Cash-generating units (CGUs)
5 Accounting treatment of an impairment loss
6 Revenue recognition
7 Current tax
8 Deferred tax
9 Taxable temporary differences
10 Deductible temporary differences
11 Measurement and recognition of deferred tax
12 Taxation in company accounts
13 Foreign currency
14 Foreign currency transactions
15 Foreign currency financial statements
16 Disclosure requirements
17 IFRS 16 *Leases*

MODULE OUTLINE

In this module, we examine a number of specific issues, including intangible assets, impairment of assets, revenue recognition, tax and foreign currency.

Intangible non-current assets are long-term assets which have a value to the business but no physical substance. In many companies, especially those which produce food or 'scientific' products such as medicines or 'high technology' products, the expenditure on **research and** development (R & D) is considerable. When R & D is a large item of cost its accounting treatment will have a significant influence on the profits of a business and its statement of financial position. As a result of this, attempts have been made to standardise the accounting treatment, and these are discussed in this module.

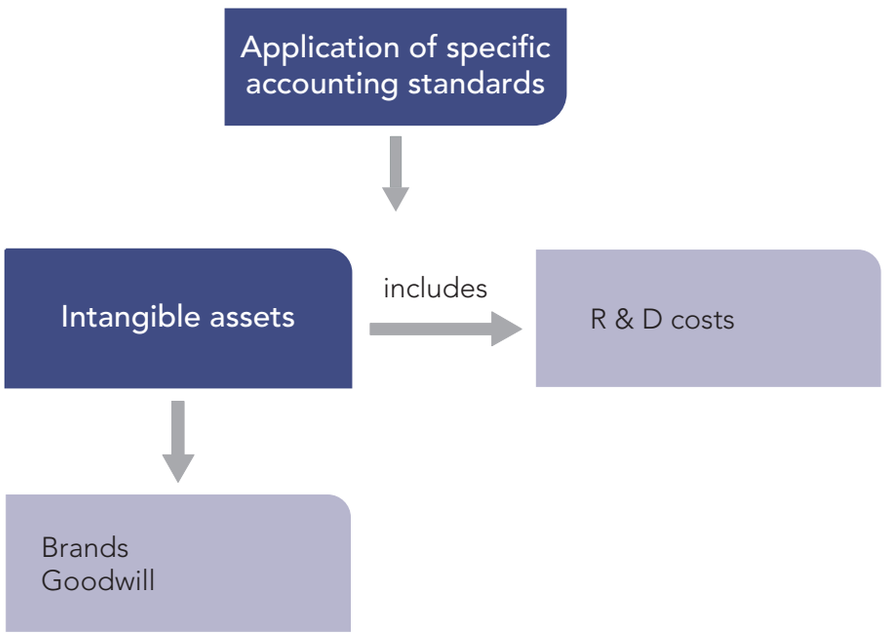
IAS 36 *Impairment of Assets* is an important Standard. It deals with falls in value, or impairments, of both tangible and intangible non-current assets and cash-generating units.

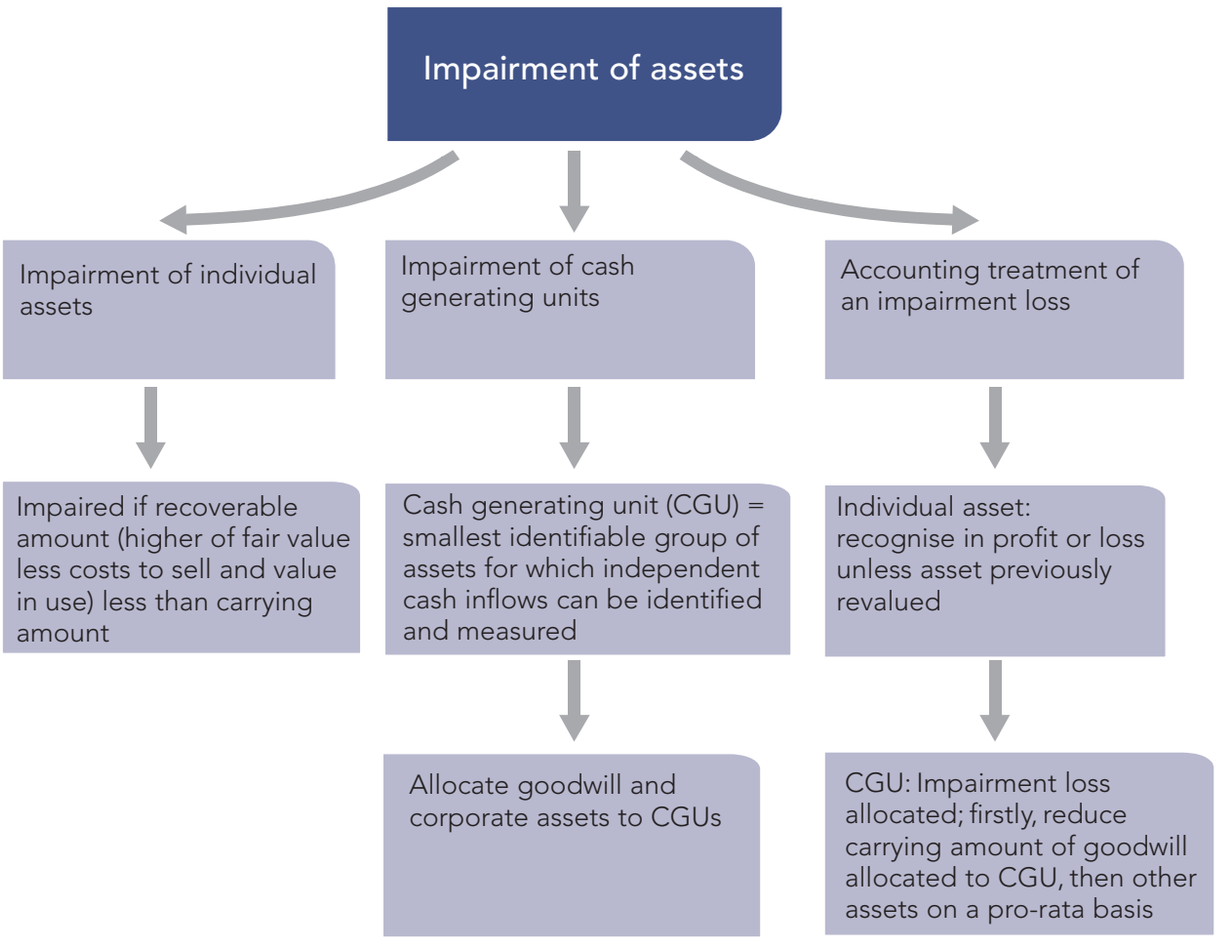
Entities are taxed on the basis of their trading profits. In some countries this may be called corporation or corporate tax, but we will follow the terminology of IAS 12 *Income Taxes* and call it income tax. There are two aspects of income tax which must be accounted for: **current tax** and **deferred tax**.

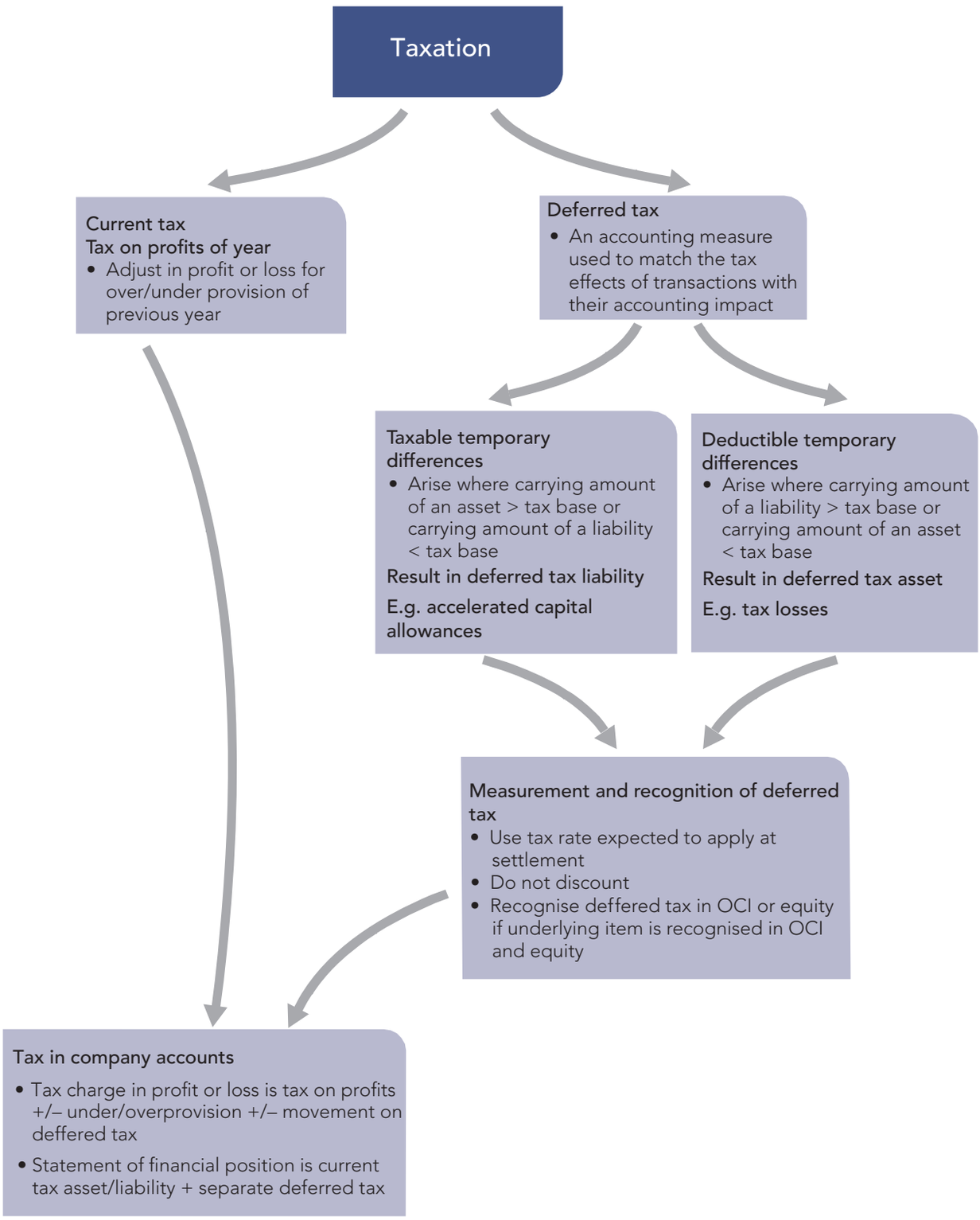
Many companies buy from overseas suppliers or sell to overseas customers. These transactions are often denominated in a foreign currency and the amount must be converted into local currency before it is recorded in the financial statements.

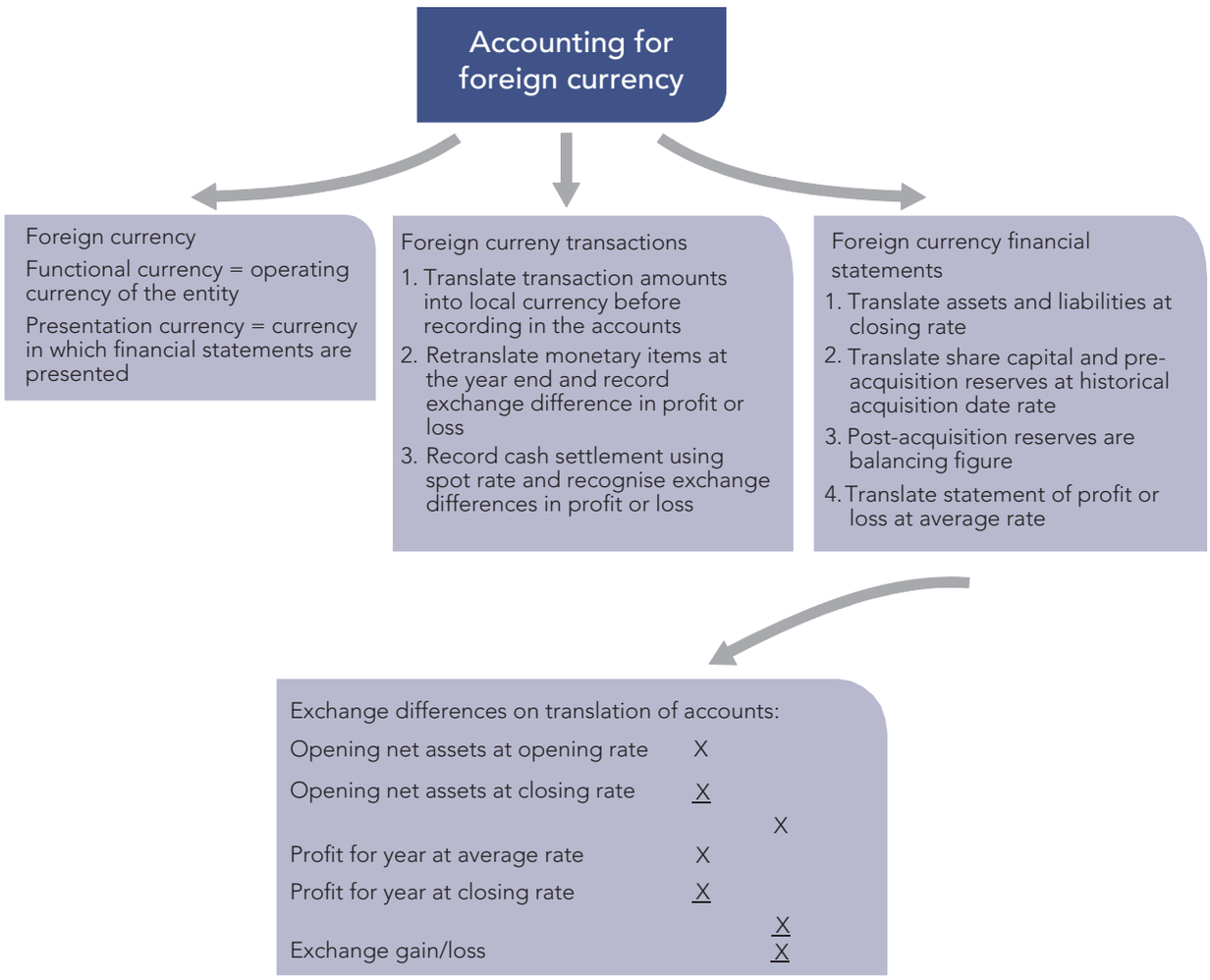
Similarly, some companies are members of a group but operate in a different country from other group companies and prepare their accounts in a different currency. Their financial statements must be translated into the currency used by the group before they can be consolidated.

The module content is summarised in the diagrams below.




Impairment of assets
Impairment of individual assets
Impairment of cash generating units
Accounting treatment of an impairment loss
Impaired if recoverable amount (higher of fair value less costs to sell and value in use) less than carrying amount
Cash generating unit (CGU) = smallest identifiable group of assets for which independent cash inflows can be identified and measured
Individual asset: recognise in profit or loss unless asset previously revalued
Allocate goodwill and corporate assets to CGUs
CGU: Impairment loss allocated; firstly, reduce carrying amount of goodwill allocated to CGU, then other assets on a pro-rata basis


Taxation
Current tax
Tax on profits of year
• Adjust in profit or loss for over/under provision of previous year
Deferred tax
• An accounting measure used to match the tax effects of transactions with their accounting impact
Taxable temporary differences
• Arise where carrying amount of an asset > tax base or carrying amount of a liability < tax base
Result in deferred tax liability
E.g. accelerated capital allowances
Deductible temporary differences
• Arise where carrying amount of a liability > tax base or carrying amount of an asset < tax base
Result in deferred tax asset
E.g. tax losses
Measurement and recognition of deferred tax
• Use tax rate expected to apply at settlement
• Do not discount
• Recognise deffered tax in OCI or equity if underlying item is recognised in OCI and equity
Tax in company accounts
• Tax charge in profit or loss is tax on profits +/– under/overprovision +/– movement on deffered tax
• Statement of financial position is current tax asset/liability + separate deferred tax



Application of specific accounting standards: Module summary diagrams

BEFORE YOU BEGIN

If you have studied these topics before, you may wonder whether you need to study this module in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the module to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the module you can find the information, and you will also find a commentary at the back of the Study Guide.

1 What is an intangible asset? (Section 1.2)
2 How is an intangible asset initially measured? (Section 1.3)
3 Under what circumstances can an intangible asset be revalued? (Section 1.4)
4 Fill in the blank: Internally generated goodwill, brands, mastheads, publishing titles and customer lists ..... be capitalised as intangible assets. (Section 1.7)
5 What is research in the context of IAS 38? (Section 2.2)
6 What is development in the context of IAS 38? (Section 2.2)
7 How are research costs accounted for? (Section 2.4.1)
8 What are the IAS 38 recognition criteria for development costs? (Section 2.4.2)
9 Identify indicators of an impairment. (Section 3.2)
10 Which assets must be tested for impairment annually? (Section 3.2)
11 What is the recoverable amount of an asset? (Section 3.3)
12 Which two amounts should be compared to identify whether an impairment loss has arisen that must be recognised? (Section 3.4)
13 Where is an impairment loss recognised? (Section 5)
14 What is a CGU? (Section 4)
15 How are impairment losses allocated to a CGU? (Section 5)
16 Which accounting standard governs revenue recognition? (Section 6)
17 What are the five steps in the approach to revenue recognition? (Section 6.5)
18 What is current tax? (Section 7.2)
19 How is current tax recorded in the financial statements? (Section 7.3)
20 What is an overprovision and how is it accounted for? (Section 7.3)
21 What is deferred tax? (Section 8.1)
22 How is a temporary difference calculated? (Section 9.1)
23 What is the tax base of an asset? (Section 8.3)
24 What is a taxable temporary difference? (Section 8.1, 9.2)
25 Give examples of situations in which a taxable temporary difference may arise. (Section 9.2)
26 What is a deductible temporary difference? (Section 8.2, 10.1)
27 Give examples of situations in which a deductible temporary difference may arise. (Section 10.2)
28 What tax rate should be applied to temporary differences? (Section 11.1)
29 Where is the movement in deferred tax recognised? (Section 11.4)
30 What elements make up the tax charged to profit or loss? (Section 12.1)
31 What is the functional currency of an entity? (Section 13.1)
32 What is the presentation currency of an entity? (Section 13.1)
33 At what rate should a foreign currency transaction be translated before it is recorded in the accounts? (Section 14.1)
34 How does an exchange difference relating to a foreign currency transaction arise and where should it be recorded? (Section 14)

35 What is a monetary item? (Section 14.3.1)

36 Where a foreign operation has a different functional currency from the reporting entity, at what rate are items in the foreign operation's statement of financial position translated from its functional currency to the reporting entity's presentation currency? (Section 15.2)

37 At what rate are items in the foreign operation's statement of profit or loss translated from functional to presentation currency? (Section 15.2)

38 What makes up the exchange difference arising on the translation of the foreign operation's financial statements into presentation currency? (Section 15.3)

39 How are leases accounted for? (Section 16.3)

40 In what situations can an entity elect to not account for leases? (Section 16.2)

1 IAS 38 *INTANGIBLE ASSETS*

LO 4.1

Section overview

- Intangible assets are defined by IAS 38 as non-monetary assets without physical substance.

'Intangible assets' are assets that have no physical substance or existence, as opposed to tangible assets (such as plant and machinery) which have a physical existence. Intangible assets include goodwill, intellectual rights (e.g. patents, performing rights and authorship rights), computer software and development costs.

1.1 THE OBJECTIVES OF IAS 38

- To establish the criteria for when an intangible asset is **recognised**
- To specify how intangible assets are **measured**
- To specify the **disclosure requirements** for intangible assets

1.2 DEFINITION OF AN INTANGIBLE ASSET

Definition

An **intangible asset** is an identifiable non-monetary asset without physical substance.

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

We shall consider the elements of this definition in turn in Sections 1.2.1–1.2.3.

1.2.1 INTANGIBLE ASSET: MUST BE IDENTIFIABLE

An intangible asset is identifiable:

- if it is **separable**, that is if it could be rented or sold separately; or
- it is a legal or contractual right.

1.2.2 INTANGIBLE ASSET: CONTROL BY THE ENTITY

Another element of the definition of an intangible asset is that it must be under the control of the entity as a result of a past event. The entity must be able to enjoy the future economic benefits from the asset, and prevent the access of others to those benefits.

- Control over **technical knowledge or know-how** only exists, and is recognisable as an intangible asset, if it is protected by a **legal right**.
- The skill of employees, and the costs of **training** are most unlikely to be recognisable as an intangible asset, because an entity does not control the future actions of its staff.
- Similarly, **market share and customer loyalty** cannot be intangible assets, because an entity cannot control the actions of its customers.

1.2.3 INTANGIBLE ASSET: EXPECTED FUTURE ECONOMIC BENEFITS

An item can only be recognised as an intangible asset if economic benefits are expected to flow in the future from ownership of the asset. Economic benefits may come from the **sale** of products or services, or from a **reduction in expenditure** (cost savings).

1.3 INITIAL MEASUREMENT OF AN INTANGIBLE ASSET

When it is acquired an intangible asset is measured at **cost**. It should be recognised if, and only if **both** the following occur:

- it is probable that the **future economic benefits** that are attributable to the asset will **flow to the entity**; and
- the **cost can be measured reliably**.

If an intangible asset is **acquired separately**, its cost can usually be measured reliably as its purchase price (including incidental costs of purchase such as legal fees, and any costs incurred in getting the asset ready for use).

When an intangible asset is acquired with other assets and liabilities as **part of a business combination** (i.e. an acquisition or takeover), the cost of the intangible asset is its fair value at the date of the acquisition.

1.4 SUBSEQUENT MEASUREMENT OF AN INTANGIBLE ASSET

The revaluation model may be applied to intangible assets only where a fair value can be established by reference to an active market. An active market is one in which items traded are homogenous, willing buyers and sellers are available and prices are made public.

In practice, there are very few examples of intangible assets that are part of an active market; possibly produce quotas and taxi licences. By definition, most intangible assets are unique and therefore do not qualify as belonging to an active market and so cannot be revalued.

Where revaluations are allowed, they should be made sufficiently regularly that the carrying amount of the asset is not materially different from its fair value.

1.5 AMORTISATION OF INTANGIBLE ASSETS

Intangible assets with a finite useful life are amortised over their useful life, beginning when the asset is available for use. Amortisation should be on a straight-line basis unless some other basis better reflects the way in which the asset's future economic benefits are expected to be consumed by the entity. The residual value of an intangible asset is nil unless there is a commitment by a third party to purchase the asset at the end of its life or there is an active market for the asset that is likely to exist at the end of its useful life.

Intangible assets with an indefinite useful life are not amortised but tested each year for impairment.

1.6 INTERNALLY GENERATED GOODWILL

Goodwill is the value to a business of its reputation, brand names, position in the market and so on. When one company buys another, purchased goodwill arises. This is discussed in more detail in Module 5. Internally generated goodwill is developed by a company over time as it builds up its reputation.

Principle to learn

Internally generated goodwill is **not** recognised as an **asset**.

The standard deliberately precludes recognition of internally generated goodwill because its cost cannot be measured reliably and it is not identifiable.

1.7 OTHER INTERNALLY GENERATED INTANGIBLE ASSETS

The Standard prohibits the recognition of internally generated brands, mastheads, publishing titles and customer lists and similar items as intangible assets. These all fail to meet one or more of (in some cases all) the definition and recognition criteria and in some cases are probably indistinguishable from internally generated goodwill.

2 RESEARCH AND DEVELOPMENT COSTS

LO 4.1

Section overview

- Expenditure on **research** must always be written off in the period in which it is incurred.
- If the criteria laid down by IAS 38 are satisfied, development expenditure must be capitalised as an **intangible asset**. If it has a **finite useful life**, it is amortised over that life.

2.1 INTRODUCTION TO R & D

Large companies may spend significant amounts of money on **research and development (R & D)** activities. Obviously, any amounts so expended must be credited to cash and debited to an account for research and development expenditure. The accounting problem is **how to treat the debit balance on R & D account** at the reporting date.

The two possible treatments are:

- The debit balance is classified as an **expense** and transferred to profit or loss. This is referred to as 'writing off' the expenditure. The argument here is that it is an expense just like rent or wages and its accounting treatment should be the same.
- The debit balance is classified as an **asset** and included in the statement of financial position. This is referred to as 'capitalising', 'carrying forward' or 'deferring' the expenditure. This argument is based on the accrual assumption. If R & D activity eventually leads to new or improved products which generate revenue, the costs should be carried forward to be matched against that revenue in future accounting periods.

So the main question surrounding R & D costs is should they be treated as an expense or capitalised as an asset.

2.2 DEFINITIONS

The following definitions are given by IAS 38.

Definitions

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

IAS 38

Although these definitions are usually well-understood, **in practice** it may not be so easy to identify the activities encompassed by R & D and the dividing line between the categories may be indistinct. Identification often depends on the type of business involved, the projects it undertakes and how it is organised.

The Standard gives examples of activities which might be included in either research or development, or which are neither but may be closely associated with both.

- Research
  - activities aimed at obtaining new knowledge;
  - the search for applications of research findings or other knowledge;
  - the search for product or process alternatives; and
  - the formulation and design of possible new or improved product or process alternatives.
- Development
  - the design, construction and testing of pre-production prototypes and models;

- the design of tools, jigs, moulds and dies involving new technology;
- the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- the design, construction and testing of a chosen alternative for new/improved materials.

2.3 COMPONENTS OF RESEARCH AND DEVELOPMENT COSTS

Research and development costs will include all costs that are **directly attributable** to research and development activities, or that can be **allocated on a reasonable basis.**

The Standard lists the costs which may be included in R & D, where applicable (note that **selling costs are excluded**):

- **salaries**, **wages** and other employment related costs of personnel engaged in R & D activities;
- costs of **materials and services** consumed in R & D activities;
- **depreciation** of property, plant and equipment to the extent that these assets are used for R & D activities;
- **overhead costs**, other than general administrative costs, related to R & D activities; these cost are allocated on bases similar to those used in allocating overhead costs to inventories (see IAS 2 *Inventories*); and
- **other costs**, such as the amortisation of patents and licences, to the extent that these assets are used for R & D activities.

2.4 RECOGNITION OF R & D COSTS

The relationship between the R & D costs and the **economic benefit** expected to be derived from them determines the allocation of those costs to different periods. Recognition of the costs as an asset will only occur where it is probable that the cost will produce future economic benefits for the entity and the costs can be measured reliably.

2.4.1 RESEARCH COSTS

Research costs are recognised as an **expense in the period in which they are incurred**. They cannot be subsequently recognised as an asset in a later period.

2.4.2 DEVELOPMENT COSTS

Development costs are recognised as an **expense in the period in which they are incurred** unless the criteria for asset recognition identified below are met. Development costs initially recognised as an expense cannot be subsequently recognised as an asset in a later period.

Development expenditure is recognised as an asset when the business can demonstrate **all** of the following (where these criteria are met, development expenditure **must** be capitalised):

- the technical feasibility of **completing** the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and **use or sell** it;
- its **ability** to use or sell the intangible asset;
- how the intangible asset will generate probable **future economic benefits**. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- the availability of adequate technical, financial and other **resources** to complete the development and to use or sell the intangible asset; and
- its ability to **measure reliably** the expenditure attributable to the intangible asset during its development.

2.5 AMORTISATION OF DEVELOPMENT COSTS

Definitions

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Once capitalised as an asset, development costs are **amortised** and recognised as an expense to match the costs with the related revenue or cost savings. This must be done on a systematic basis, to reflect the pattern in which the related economic benefits are recognised. If no other pattern can be identified then the straight-line method should be used.

The amortisation will begin when the **asset is available for use**. Until the asset is available for use it should be subject to an annual impairment review.

If the intangible asset is considered to have an **indefinite** useful life, it is not amortised but subjected to an annual impairment review.

2.6 IMPAIRMENT OF DEVELOPMENT COSTS

As with all assets, impairment (fall in value of an asset) is a possibility. The development costs should be **written down** to the extent that the unamortised balance (taken together with further development costs, related production costs, and selling and administrative costs directly incurred in marketing the product) exceeds the expected future economic benefits. This is covered later in the module.

2.7 DISCLOSURE

The Standard has fairly extensive disclosure requirements for intangible assets. The financial statements should disclose the **accounting policies** that have been adopted for intangible assets.

For **each class of intangible assets** (including development costs), disclosure is required of the following:

- the **method of amortisation** used;
- the **useful life** of the assets or the amortisation rate used;
- the **gross carrying amount**, the **accumulated amortisation** and the **accumulated impairment losses** as at the beginning and the end of the period;
- a **reconciliation of the carrying amount** as at the beginning and at the end of the period (additions, retirements/disposals, revaluations, impairment losses, impairment losses reversed, amortisation charge for the period, net exchange differences, other movements);
- the line item to which amortisation has been charged in the SPLOCI; and
- the carrying amount of **internally-generated intangible assets (development).**

An entity should also disclose the amount of research and development expenditure charged as an **expense**.

Question 1: Y Co. (1)

Y Co. is a research company which specialises in developing new materials and manufacturing processes for the furniture industry. The company receives payments from a variety of manufacturers, which pay for the right to use the company's patented fabrics and processes.

Research and development costs for the year ended 30 September 20X5 can be analysed as follows:

	$
Expenditure on continuing research projects	1 420 000
Amortisation of development expenditure capitalised in earlier years	240 000
New projects started during the year:	
Project A	280 000
New flame-proof padding. Expected to cost a total of $800 000 to develop. Expected total revenue $2 000 000 once work completed – probably late 20X6.	
Project B	150 000
New colour-fast dye. Expected to cost a total of $3 000 000 to complete. Future revenues are likely to exceed $5 000 000. The completion date is uncertain because external funding will have to be obtained before research work can be completed.	
Project C	110 000
Investigation of new adhesive recently developed in aerospace industry. If this proves effective then Y Co. may well generate significant income because it will be used in place of existing adhesives.	
	2 200 000

Required

Explain how the three research projects A, B and C will be dealt with in Y Co.'s statement of profit or loss and other comprehensive income and statement of financial position.

In each case, explain your proposed treatment in terms of IAS 38 *Intangible Assets*.

(The answer is at the end of the module.)

Question 2: Y Co. (2)

Show how the research and development costs in the previous question will be disclosed in the financial statements of Y Co. listed below.

(a) statement of profit or loss and other comprehensive income

(b) statement of financial position

(c) notes to the financial statements.

Assume the cost of capitalised development expenditure brought forward is $1 480 000, and that accumulated amortisation of $240 000 was brought forward at the beginning of the year.

(The answer is at the end of the module.)

3 IMPAIRMENT OF INDIVIDUAL ASSETS

LO 4.1

Section overview

- Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its **fair value** less **costs of disposal** and its **value in use**.

There is an established principle that assets are not carried at above their recoverable amount. An entity should write down the carrying amount of an asset to its recoverable amount. IAS 36 *Impairment of Assets* covers impairment reviews and related accounting treatments and disclosures.

3.1 SCOPE

IAS 36 applies to most tangible and intangible assets, but certain asset types are excluded because they are covered specifically by another Standard. These include inventories (covered by IAS 2), assets arising from construction contracts, deferred tax assets (IAS 12), financial assets that are within the scope of IFRS 9, investment property that is measured at fair value (IAS 40) and a small number of other asset types. This is because these standards already have rules for recognising and measuring impairment,

Definitions

Impairment: a fall in the value of an asset, so that its 'recoverable amount' is less than its carrying amount.

Carrying amount: is the amount at which an asset is recognised after deducting accumulated depreciation and impairments. *(IAS 36)*

The basic principle underlying IAS 36 is relatively straightforward. If an asset's value in the accounts is higher than its 'recoverable amount', the asset has suffered an impairment loss. It should therefore be reduced in value, by the amount of the **impairment loss**. The general rule is that the amount of the impairment loss should be **written off against profit or loss** immediately (exceptions will be covered later).

The main accounting issues to consider are:

- How to **identify when** an impairment loss may have occurred?
- How should the **recoverable amount** of the asset be measured?
- How should an 'impairment loss' be **reported in the accounts**?

3.2 IDENTIFYING A POTENTIALLY IMPAIRED ASSET

An entity should assess at the end of each reporting period whether there are any indications of impairment. The concept of **materiality** applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the entity must estimate the **recoverable amount** of the assets concerned.

IAS 36 suggests **indications of a possible impairment.** The suggestions are based largely on common sense.

- **External sources of information**
  - A fall in the asset's market value that is more significant than would normally be expected from passage of time or normal use.
  - A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.
  - An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.

  - The carrying amount of the entity's net assets being more than its market capitalisation.
- **Internal sources of information**: evidence of obsolescence or physical damage, adverse changes in the use to which the asset is put, or the asset's economic performance.

Even if there are no indications of impairment, the following assets must **always** be tested for impairment annually:

- an intangible asset with an **indefinite useful life**;
- an intangible asset which is not yet available for use; and
- **goodwill** acquired in a business combination.

3.3 MEASURING THE RECOVERABLE AMOUNT OF THE ASSET

What is an asset's recoverable amount?

Definition

The recoverable amount of an asset is the **higher value** of:

- the asset's fair value less costs of disposal; and
- its value in use. *(IAS 36)*

An asset's fair value less costs of disposal is the amount net of selling costs that could be obtained from the sale of the asset. Selling costs include sales transaction costs, such as legal expenses. Selling costs do not include **restructuring or reorganisation expenses**, or any costs that have already been recognised in the financial statements.

The concept of 'value in use' is very important.

Definition

The value in use of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its expected useful life.

3.4 RECOGNITION AND MEASUREMENT OF AN IMPAIRMENT LOSS

The rule for assets at historical cost is:

Rule to learn

If the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (i.e. the impairment loss) which should be charged as an expense in profit or loss.

The rule for assets held at a revalued amount (such as property revalued under IAS 16) is:

Rule to learn

The impairment loss is to be treated as a revaluation decrease under the relevant IAS.

In practice this means:

- To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to the revaluation surplus.
- Any excess should be charged to profit or loss.

Once reduced to recoverable amount, the **depreciation charge** on the asset is based on recoverable amount, estimated residual value (if any) and estimated remaining useful life.

Worked Example: Impairment and depreciation charge

Two years ago a company bought a machine for $500 000. Depreciation has been charged straight line over five years assuming no residual value. Now the machine has a value in use of $270 000 and the fair value less costs of disposal is $120 000. Its useful life is still estimated as five years from acquisition and residual value is still expected to be zero. Calculate and record the impairment and the future depreciation charge.

Solution

The carrying amount now will be $300 000 (being the cost of $500 000 less two years depreciation at $100 000 each year).

The recoverable amount is the higher of $270 000 and $120 000 which is $270 000.

The carrying amount is written down by the impairment of $30 000.

Dr.	Impairment expense	$30 000	
Cr.	Accumulated impairment losses		$30 000

The future depreciation charge will be $270 000 / 3 years = $90 000 each year

4 CASH-GENERATING UNITS (CGUs)

Section overview

- When it is not possible to calculate the recoverable amount of a single asset, that of its **cash-generating unit** should be measured instead.

The IAS goes into quite a large amount of detail about the important concept of cash-generating units. As a basic rule, the recoverable amount of an asset should be calculated for the **asset individually**. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows and outflows cannot be attributed to the individual asset.

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash-generating unit should be measured instead.

Definition

A cash-generating unit is the smallest identifiable group of assets for which independent cash inflows can be identified and measured.

Question 3: Cash-generating unit

Can you think of some examples of how a cash-generating unit would be identified?

(The answer is at the end of the module.)

Question 4: Cash-generating unit

Minimart belongs to a retail store chain Maximart. Minimart makes all its retail purchases through Maximart's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring Minimart's cashiers and sales staff) are decided by Maximart. Maximart also owns five other stores in the same city as Minimart (although in different neighbourhoods) and 20 stores in other cities. All stores are managed in the same way as Minimart. Minimart and four other stores were purchased five years ago and goodwill was recognised.

Required

What is the cash-generating unit for Minimart?

(The answer is at the end of the module.)

Cash-generating units should be identified consistently from period to period for the same type of asset unless a change is justified.

The group of net assets less liabilities that are considered for impairment should be the same as those considered in the calculation of the recoverable amount. (For the treatment of goodwill and corporate assets see below.)

4.1 ALLOCATING GOODWILL TO CASH-GENERATING UNITS

Goodwill acquired in a business combination does not generate cash flows independently of other assets. It must be **allocated** to the acquirer's **cash-generating units** (or groups of cash-generating units) that are expected to benefit from the synergies of the combination.

4.2 TESTING CASH-GENERATING UNITS WITH GOODWILL FOR IMPAIRMENT

There are two situations to consider:

- Where goodwill has been allocated to a cash-generating unit.
- Where it has not been possible to allocate goodwill to a specific cash-generating unit, but only to a group of units.

A cash-generating unit to which goodwill has been allocated is tested for impairment annually. The **carrying amount** of the unit, including goodwill, is **compared with the recoverable amount**. If the carrying amount of the unit exceeds the recoverable amount, the entity must recognise an impairment loss.

Where goodwill relates to a cash-generating unit but has not been allocated to that unit, the unit is tested for impairment by **comparing its carrying amount** (excluding goodwill) **with its recoverable amount**. The entity must recognise an impairment loss if the carrying amount exceeds the recoverable amount.

The annual impairment test may be performed at any time during an accounting period, but must be performed at the **same time every year**.

4.3 CORPORATE ASSETS

Corporate assets are assets such as a head office building, computer equipment or a research centre. Essentially, corporate assets are assets that do not generate cash inflows independently from other assets. Therefore, their carrying amount cannot be fully attributed to a single cash-generating unit under review.

In testing a cash-generating unit for impairment, an entity should identify all the corporate assets that relate to the cash-generating unit:

- If a portion of the carrying amount of a corporate asset **can be allocated** to the unit on a reasonable and consistent basis, the entity compares the carrying amount of the unit (including the portion of the asset) with its recoverable amount.

- If a portion of the carrying amount of a corporate asset **cannot be allocated** to the unit on a reasonable and consistent basis, the entity:
  - compares the carrying amount of the unit (excluding the asset) with its recoverable amount and recognises any impairment loss
  - identifies the smallest group of cash-generating units that includes the cash-generating unit to which the asset belongs and to which a portion of the carrying amount of the asset can be allocated on a reasonable and consistent basis
  - compares the carrying amount of that group of cash-generating units (including the portion of the asset allocated to the group of units) with the recoverable amount of the group of units and recognises any impairment loss.

5 ACCOUNTING TREATMENT OF AN IMPAIRMENT LOSS

LO 4.1

Section overview

- An impairment loss is recognised immediately in profit or loss unless the asset has been revalued, in which case the loss is treated as a revaluation decrease.

If, and only if, the recoverable amount of an asset is less than its carrying amount in the statement of financial position, an impairment loss has occurred. This loss should be **recognised immediately**.

As we saw earlier:

(a) The asset's **carrying amount** should be reduced to its recoverable amount in the statement of financial position.

(b) The **impairment loss** should be recognised immediately in profit or loss (unless the asset has been revalued in which case the loss is treated as a revaluation decrease).

After reducing an asset to its recoverable amount, the **depreciation charge** on the asset should then be based on its new carrying amount, its estimated residual value (if any) and its estimated remaining useful life.

An impairment loss is recognised for a **cash-generating unit** if the recoverable amount for the cash-generating unit is less than the carrying amount of all the assets in the unit. When an impairment loss is recognised for a cash-generating unit, the loss is allocated between the assets in the unit in the following order:

- first, to any assets that are obviously damaged or destroyed
- next, to the **goodwill** allocated to the cash-generating unit
- then to all other assets in the cash-generating unit, on a **pro rata basis**.

Note that point (c) refers to 'all other assets in the cash-generating unit', however remember that some assets such as inventory are outside the scope of IAS 36 (see Section 1.1) and are therefore not included within 'all other assets'.

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

- its fair value less costs of disposal
- its value in use (if determinable)
- zero.

Any remaining amount of an impairment loss should be recognised as a liability if required by other IFRSs.

Worked Example: Impairment loss (1)

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its financial statements for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

(a) Its carrying amount in the statement of financial position is $3m.

(b) The company has received an offer of $2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.

(c) The present value of the estimated cash flows from the platform's continued use is $3.3m (before adjusting for dismantling costs).

(d) The carrying amount in the statement of financial position for the provision (a liability) for dismantling and removal is currently $0.6m.

What should be the value of the drilling platform in the statement of financial position, and what, if anything, is the impairment loss?

Solution

Fair value less costs of disposal	=	$2.8m
Value in use	=	PV of cash flows from use less the carrying amount of the provision / liability = $3.3m – $0.6m = $2.7m
Recoverable amount	=	Higher of these two amounts, i.e. $2.8m
Carrying amount	=	$3m
Impairment loss	=	$0.2m

The carrying amount should be reduced to $2.8m.

Worked Example: Impairment loss (2)

A company has acquired another business for $4.5m: tangible assets are valued at $4.0m and goodwill at $0.5m.

An asset with a carrying amount of $1m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to assess whether there has been an impairment of assets in the acquired business and what the amount of any such loss is.

The recoverable amount of the business (a single cash-generating unit) is measured as $3.1m.

Solution

There has been an impairment loss of $1.4m ($4.5m – $3.1m).

The impairment loss will be recognised in profit or loss. The loss will be allocated between the assets in the cash-generating unit as follows:

(a) A loss of $1m can be attributed directly to the uninsured asset that has been destroyed.

(b) The remaining loss of $0.4m should be allocated to goodwill.

The carrying amount of the assets will now be $3m for tangible assets and $0.1m for goodwill.

5.1 REVERSAL OF AN IMPAIRMENT LOSS

The annual assessment to determine whether there may have been some impairment should be **applied to all assets**, including assets that have already been impaired in the past.

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be **higher** than the asset's current carrying amount. In other words, there might have been a reversal of some of the previous impairment loss.

In this case, the carrying amount of the asset is increased to its **new recoverable amount**, which should not exceed the asset's carrying amount at that date had the original impairment loss not occurred.

- A reversal of an impairment loss on an asset held at historic cost is recognised immediately in profit or loss.
- A reversal of an impairment loss on a revalued asset is recognised in profit or loss to the extent that the original impairment loss was recognised in profit or loss. The balance of the reversal is recognised as other comprehensive income and increases the revaluation surplus for that asset.

An exception to this rule is for **goodwill**. An impairment loss for goodwill is not reversed.

Question 5: Reversal of impairment loss

A cash-generating unit comprising a factory, plant and equipment etc. and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash-generating unit falls to $60m, resulting in an impairment loss of $80m, allocated as follows:

	Carrying amounts before impairment	Carrying amounts after impairment
	$m	$m
Goodwill	40	–
Patent (with no market value)	20	–
Tangible non-current assets (market value $60m)	80	60
Total	140	60

After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the cash-generating unit increases to $90m. The carrying amount of the tangible non-current assets had the impairment not occurred would have been $70m.

Required

Calculate the reversal of the impairment loss and explains how it should be accounted for.

(The answer is at the end of the module.)

KEY MODULE POINTS 1

- An intangible asset is defined by IAS 38 as an identifiable non-monetary asset without physical substance which is:
  - controlled by an entity as a result of a past event; and
  - expected to generate future economic benefits to the entity.
- An intangible asset which meets the recognition criteria of the *Conceptual Framework* is initially measured at cost.
- The revaluation model may subsequently be applied to intangible assets only where a fair value can be established by reference to an active market.
- Intangible assets with a finite useful life are amortised over that useful life, beginning when the asset is available for use.
- Intangible assets with an indefinite useful life are not amortised but tested each year for impairment and in addition whenever there are indications of impairment.
- Internally generated goodwill may not be recognised as an asset.
- Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- Expenditure on research must always be written off in the period in which it is incurred.
- Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.
- Expenditure on development is written off unless it meets the IAS 38 capitalisation criteria. In this case it is capitalised at cost and amortised.
- Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its fair value less costs of disposal and its value in use.
- If the recoverable amount of an asset is lower than the carrying amount, the carrying amount is reduced by the difference.
- For an asset held at historical cost, the impairment is charged as an expense in profit or loss.
- For a revalued asset, the impairment loss is treated as a revaluation decrease under the relevant IFRS.
- When it is not possible to calculate the recoverable amount of a single asset, then that of its cash-generating unit is measured instead.
- A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- Goodwill and corporate assets must be allocated to each of the acquirer's cash-generating units (or groups of cash-generating units) that are expected to benefit from the synergies of the combination.
- When an impairment loss is recognised for a cash-generating unit, the loss is allocated between the assets in the unit in the following order:
  - first, to any assets that are obviously damaged or destroyed
  - next, to the goodwill allocated to the cash-generating unit
  - then to all other assets in the cash-generating unit (and within the scope of IAS 36) on a pro rata basis.

QUICK REVISION QUESTIONS 1

1 XY Co. has development expenditure of $500 000. Its policy is to amortise development expenditure at 2 per cent per annum. Accumulated amortisation brought forward is $20 000. What is the amount shown in the statement of financial position at the year end for development expenditure?

A $470 000
B $480 000
C $490 000
D $500 000

2 Which of the following statements about research and development expenditure are correct according to IAS 38 *Intangible Assets*?

I. If certain conditions are met, an entity may decide to capitalise development expenditure.
II. Capitalised development expenditure must be amortised over a period not exceeding five years.
III. Research expenditure, other than capital expenditure on research facilities, must be written off as incurred.
IV. Capitalised development expenditure must be classified in the statement of financial position under intangible non-current assets.

A I and II only
B II and IV only
C III and IV only
D I, III and IV only

3 Which of the following should be capitalised as development expenditure?

A A Co. has incurred $140 000 investigating whether a newly identified plant has medicinal properties, and found that it does.
B B Co. has found that a particular chemical compound may be useful in combating flu. A number of large pharmaceutical companies are providing financial backing for B Co.
C C Co. has produced a prototype of a new product however trials in its use have revealed a number of flaws. C Co. is currently working on overcoming these flaws with little success.
D D Co. has spent $90 000 making a new fabric resistant to the sun's rays for use in children's clothing. Several large manufacturers are interested in the fabric which will be ready for production in the coming year.

4 In the current year High Co. has developed a new heat retaining fabric from which clothing suitable for high altitudes will be made. The project meets the IAS 38 criteria for capitalisation and by 30 June 20X8, $210 000 had been capitalised.

The fabric is expected to generate revenue for 10 years from the date on which commercial production commenced on 1 November 20X7, although in the first year only half of the revenue of subsequent years is anticipated. What amount is charged to profit or loss in respect of the fabric in the year ended 30 June 20X8?

A $7368
B $11 053
C $14 000
D $21 000

5 Cranford Co. has incurred $40 000 researching chemical compounds in the year ended 30 June 20X8. It has also spent $90 000 developing a new product. The product's development was completed on 28 February but management has decided to delay commercial production until July 20X8. The product is expected to have a useful life of five years. The development project meets the IAS 38 capitalisation criteria. How should these costs be treated in the year ended 30 June 20X8?

A $130 000 should be written off to profit or loss
B $46 000 should be written off to profit or loss and $84 000 recognised as an intangible asset
C $40 000 should be written off to profit or loss and $90 000 recognised as an intangible asset
D $100 000 should be written off to profit or loss and $30 000 recognised as an intangible asset

6 Which of the following four statements is correct?

A Capitalised development expenditure must be amortised over a period not exceeding five years.
B Capitalised development costs are classified in the statement of financial position as non-current assets.
C Amortisation of capitalised development expenditure will appear as an item in a company's statement of changes in equity.
D If all the conditions specified in IAS 38 *Intangible Assets* are met, the directors can choose whether to capitalise the development expenditure or not.

7 Which of the following are IAS 38 criteria which must be met in order to capitalise an intangible non-current asset?

I. The asset must be capable of separate disposal.
II. The asset must be within the control of the entity.
III. It is probable that future economic benefits will flow to the entity as a result of the asset.

A I and II only
B I and III only
C II and III only
D I, II and III

8 Which of the following is correct?

A An intangible asset must be amortised.
B Market share may be recognised as an intangible asset.
C Intangible assets with an indefinite useful life must be reviewed for impairment annually.
D Internally generated goodwill can be recognised in the financial statements by reference to the amount of purchased goodwill of a similar company.

9 Choc Co. acquires a chocolate bar brand from a competitor for $900 000 on 1 August 20X9. The brand is considered by Choc Co. to have a useful life of 25 years, and in order to maintain its market position, Choc Co. have, since acquisition, spent $100 000 on a marketing campaign. What intangible asset is recognised in Choc Co.'s statement of financial position at 31 December 20X9?

A $864 000
B $885 000
C $964 000
D $985 000

10 Clever Co. has incurred the following costs in the course of the year ended 30 June 20X9:

- $400 000 training selected staff members to be 'World Class Knowledge Holders' (an internal qualification which is believed to result in increased sales).
- $100 000 acquiring patents.
- $200 000 advertising new products. The advertising is expected to result in a doubling of sales in the coming year.

What amount should Clever Co. capitalise as an intangible asset in respect of these items in the year ended 30 June 20X9?

A $100 000
B $300 000
C $500 000
D $600 000

11 Which of the following represents the correct treatment of a revaluation surplus arising on a property and an impairment loss on an asset which has not previously been revalued?

	Revaluation surplus	Impairment loss
A	Profit or loss	Profit or loss
B	Other comprehensive income	Profit or loss
C	Profit or loss	Other comprehensive income
D	Other comprehensive income	Other comprehensive income

12 At 1 May 20X4 the revaluation surplus of Bloxden was $1 257 000. This was in respect of the company's head office.

During the year to 30 April 20X5 the value of the head office increased by a further $82 000. In the same period, the company's factory suffered an impairment of $90 000.

What is the value of the revaluation surplus at 30 April 20X5?

A $1 167 000
B $1 249 000
C $1 257 000
D $1 339 000

13 Which of the following statements about IAS 36 *Impairment of Assets* are correct?

I. Non-current assets must undergo an annual impairment test.
II. If individual assets cannot be tested for impairment, it may be necessary to test a group of assets as a unit.
III. An impairment loss must be recognised immediately in profit or loss, except that all or part of a loss on a revalued asset should be charged against any related revaluation surplus.

A I and II only
B I and III only
C II and III only
D I, II and III

14 A cash-generating unit comprises the following:

	$m
Building	20
Plant and equipment	10
Goodwill	5
Current assets	10
	45

Following a downturn in the market, an impairment review has been undertaken and the recoverable amount of the cash-generating unit is estimated to be $25m.

What is the carrying amount of the building after adjusting for the impairment loss?

A $10m
B $11m
C $12.5m
D $20m

15 On 1 January 20X5 Plane Co. acquired 60 per cent of the equity share capital of Sycamore Co. Goodwill of $100 000 arose on the acquisition.

Sycamore Co.'s performance for the years ended 31 December 20X5 and 31 December 20X6 slightly exceeded budget. However, in the year ended 31 December 20X7 it made substantial losses that had not been forecast.

The goodwill arising on the acquisition of Sycamore Co. should be reviewed for impairment

A in 20X5
B in 20X7
C annually
D in 20X5 and in 20X7

16 Man Co. bought a property on 1 April 20X5 costing $700 000 and commenced depreciation over a 50-year period. On 1 April 20X7, the property was revalued to $960 000 and depreciation continued over the remaining useful life. Man Co. makes an annual reserve transfer in respect of excess depreciation. On 31 March 20X8, as the result of fire damage, the property was found to be impaired with a recoverable amount of $600 000.

Which of the following is correct for the year ended 31 March 20X8?

A An impairment loss of $340 000 arises, $288 000 is debited to the revaluation surplus and $64 000 to profit or loss
B An impairment loss of $340 000 arises, $282 000 is debited to the revaluation surplus and $58 000 to profit or loss
C An impairment loss of $340 800 arises, $282 800 is debited to the revaluation surplus and $58 000 to profit or loss
D An impairment loss of $340 800 arises, $288 000 is debited to the revaluation surplus and $52 800 to profit or loss

17 Skipton Co. bought land 11 years ago in 20W8 at a cost of $300 000. In 20X3 the land was revalued to $350 000 and in 20X6 it was revalued again to $400 000. At the end of 20X9 the land had a value in use of $270 000 and the fair value less costs of disposal was $285 000.

How is the resulting impairment loss recorded?

A $50 000 as other comprehensive income and $65 000 in profit or loss
B $50 000 as other comprehensive income and $80 000 in profit or loss
C $100 000 as other comprehensive income and $15 000 in profit or loss
D $100 000 as other comprehensive income and $30 000 in profit or loss

18 Pannal Co. recorded an impairment of its goodwill five years ago, reducing the carrying amount by half. The management of Pannal now believes that the value of goodwill has increased again to 75 per cent of its original value. Which of the following is correct?

A The reversal of the impairment loss cannot be recognised.
B The reversal of the impairment loss should be recognised in profit or loss.
C The reversal of the impairment loss should be recognised in other comprehensive income.
D The reversal of the impairment loss is recognised in either other comprehensive income or profit or loss depending on how the initial impairment was recognised.

19 Denton Co. acquired a piece of machinery on 1 July 20X7 for $80 000 and commenced depreciation on a straight-line basis over 10 years. At 31 December 20X8, the machine was tested for impairment as a result of a downturn in the market. It was found to have a value in use of $66 000 and the fair value less costs of disposal was $60 000.

What was the depreciation charge on the machine in the year ended 31 December 20X9 assuming that there was no change in useful life?

A $7059
B $7529
C $7765
D $8000

20 Which of the following statements is correct?

I. An intangible asset with an indefinite useful life must be tested for impairment at the end of each reporting period.
II. A head office building which is shared by a number of cash-generating units is always tested for impairment on an individual basis.

A I only
B II only
C both statements
D neither statement

6 REVENUE RECOGNITION

LO 4.2

Section overview

- Revenue recognition is straightforward for most business transactions, but some situations are more complicated and some give opportunities for manipulation.

6.1 INTRODUCTION

Frequently the largest single number in the statement of profit or loss and other comprehensive income is revenue. Of particular concern is when revenue should be recognised. Accruals accounting is based on the **matching of costs with the revenue they generate**. It is therefore crucially important that we establish the point at which revenue is recognised so that the correct treatment is applied to related costs. For example, the costs of producing an item of finished goods should be carried as an asset in the statement of financial position until such time as it is sold; then they are written off as a charge to profit or loss. Which of these two treatments should be applied cannot be decided until it is clear at what moment the sale of the item takes place.

6.2 IFRS 15 *REVENUE FROM CONTRACTS WITH CUSTOMERS*

The key principle within IFRS 15 is that revenue is recognised when there is a transfer of control to the customer from the entity supplying the goods or services.

IFRS 15 *Revenue from Contracts with Customers* was issued in May 2014, replacing both IAS 18 *Revenue* and IAS 11 *Construction Contracts*. It is effective for reporting periods beginning on or after 1 January 2018.

Under IFRS 15 the transfer of goods and services is based upon the transfer of **control**, rather than the transfer of risks and rewards as in IAS 18. **Control of an asset** is described in the standard as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

6.3 SCOPE

IFRS 15 applies to all contracts with customers except:

- leases within the scope of IFRS 16;
- insurance contracts within the scope of IFRS 4;
- financial instruments and other contractual rights and obligations within the scope of IFRS 9, IFRS 10, IFRS 11, IAS 27 or IAS 28; and
- non-monetary exchanges between entities in the same line of business.

6.4 DEFINITIONS

The following definitions are given in the Standard.

Definitions

Income: increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

Revenue: income arising in the course of an entity's ordinary activities.

Contract: an agreement between two or more parties that creates enforceable rights and obligations.

Performance obligation: a promise in a contract with a customer to transfer to the customer either:

- a good or service (or a bundle of goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Stand-alone selling price: the price at which an entity would sell a promised good or service separately to a customer.

Transaction price: the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. (IFRS 15)

Revenue **does not include** sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an economic benefit flowing to the entity. The same is true for revenues collected by an agent on behalf of a principal. Revenue for the agent is only the commission received for acting as agent.

6.5 RECOGNITION AND MEASUREMENT OF REVENUE

IFRS 15 sets out a five-step model to be applied for the recognition of revenue:

Step 1 **Identify the contract with the customer.**

A contract is only within the scope of IFRS 15 when:

- the parties are committed to carrying it out;
- each party's rights to be transferred can be identified;
- the payment terms can be identified;
- the contract has commercial substance; and
- it is probable that the entity will collect the consideration.

A contract can be written, verbal or implied.

Step 2 **Identify the separate performance obligations.** A performance obligation is a promise to transfer a good or a service to a customer. Performance obligations should be accounted for separately provided the good or service is distinct. When a promised good or service is not distinct it is combined.

A good or service is considered to be distinct if it could be sold separately.

Step 3 **Determine the transaction price.** The amount to which the entity expects to be entitled.

For variable consideration probability-weighted expected value or most likely amount is used. An example of variable consideration is settlement discounts.

Discounting is not required where less than a year.

Step 4 **Allocate the transaction price to the performance obligations.** Where a contract contains more than one distinct performance obligation a company allocates the transaction price to the separate performance obligations in proportion to the relative stand-alone selling price of each performance obligation.

Step 5 **Recognise revenue when or as a performance obligation is satisfied.** The entity satisfies a performance obligation by transferring control of a promised good or service to the customer. This could be at a point in time when goods are delivered to a customer, or over a period of time.

An obligation satisfied **over time** is recognised when one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits as the performance takes place.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

  The amount of revenue recognised is the amount allocated to that performance obligation in Step 4.

  An entity must be able to **reasonably measure** the outcome of a performance obligation before the related revenue can be recognised.

6.6 WORKED EXAMPLES TO ILLUSTRATE THE FIVE-STEP MODEL

Worked Example: Identifying performance obligations

A company sells 200 washing machines for $500 each and includes a one-year warranty. The warranty cannot be purchased separately. How does the business account for this sale?

Solution

The customer does not have the option to purchase the warranty separately which means there is only one performance obligation in the contract, the supply of a washing machine.

The business will recognise revenue of $100 000 ($500 × 200). The business would then apply IAS 37 to determine the level of provision required in respect of the obligations under the warranties.

Worked Example: Identifying separate performance obligations

A computerised accountancy package is sold with one year's after-sales technical support. The technical support can be purchased from other suppliers. How many performance obligations are there in this contract?

Solution

As the customer could purchase the technical support separately this would be a distinct performance obligation. There are two performance obligations in this contract:

The sale of the accountancy package and the sale of the one year's technical support.

Worked Example: Determining the transaction price

Alex made sales of goods on credit to Emily. The cost of the goods was $4000 but he offered her a 5 per cent trade discount and an additional 5 per cent discount if she paid within 14 days. What is the transaction price for this sale?

Solution

Alex should calculate the transaction price after any trade discounts offered to customers and after any settlements discounts he expects the customer to take. Assuming he expects Emily to pay within the 14 days the transaction price would be $3610 ($4000 × 95% = $3800) and then the additional 5 per cent is applied as Alex expects Emily to take up the discount ($3800 × 95% =$3610)
The settlement discount is variable consideration and per IFRS 15 it should be determined by reference to the amount of revenue that is expected to be received.

If Alex did not expect Emily to pay within the 14 days then the settlement discount would be ignored as the expected consideration would be $3800 ($4000 × 95%).

IFRS 15 has changed the accounting for settlement discounts allowed to customers and you may have learnt different treatment in your previous studies. **In section 6.8 there are more detailed examples of how to account for discounts allowed.**

Worked Example: Allocating the transaction price to the performance obligations

A mobile phone company gives a free handset to customers when they sign up for a three-year mobile phone service for $15 a month. The handset would cost $200 if bought separately. How should they allocate the transaction price to the performance obligations?

Solution

There are two performance obligations within the contract – the provision of the handset and the provision of the mobile phone service for three years. The total revenue of $540 ($15 × 36 months) must be allocated as follows:

	$	%
Handset	200	27
Mobile phones services	540	73
Total	740	100

The customer is receiving a discount of $200 and they are only paying $540 in total and this needs to be allocated to the two performance obligations.

Year 1	$
Handset (540 × 27%)	146
Mobile phone services (540 × 73% = 394 / 3 years)	131

In Year 1 revenue on the handset can be recognised as the performance obligation is satisfied when the customer receives the handset. The revenue on the mobile phone services will be recognised over the three years as the performance obligation is satisfied over a period of time.

6.7 CONTRACTS WHERE PERFORMANCE OBLIGATIONS ARE SATISFIED OVER TIME

A construction company is building a new hotel for a client and they expect it to take three years to complete. Over the three years they receive payments from the client and they will incur costs to build the hotel such as building materials and labour costs.

Applying the five step model under IFRS 15 to this contract it would be a contract in which the performance obligation is satisfied over a period of time. The contract meets the criteria in IFRS 15 as the entity is carrying out the work for the benefit of the customer rather than creating an asset for its own use and in this case it has an enforceable right to payment for work completed to date.

Worked Example: Construction contract

A building company is contracted to build a new factory for a client on 1 January 20X4 for an agreed price of $4 000 000. On 31 December 20X4 the company has incurred costs to date of $1 000 000 and they are reasonably certain that the additional costs to complete the factory will be $2 000 000. The building company have invoiced the company $1 250 000 and the client has paid this.

A surveyor has reviewed the work completed and confirmed that the value of work completed is worth $1 500 000.

Discuss how the building company should account for this contract for the year ended 31 December 20X4.

Solution

This is a contract in which the performance obligation is satisfied over time. The entity is carrying out the work for the benefit of the customer rather than creating an asset for its own use and in this case it has an enforceable right to payment for work completed to date. This can be seen by the issuing of an invoice which the client has paid.

Applying IFRS 15, the building company will need to measure the amount of performance obligations completed to date using an appropriate method. One method would be to measure the revenue by comparing the value of work performed to the total contract value. In this example this would mean that the contract is 37.5 per cent complete at 31 December 20X4 (1.5m/4m).

The same percentage will be used to calculate the costs that should be reflected in profit or loss. This would give costs of $1 125 000 calculated as 37.5 per cent of costs incurred to date plus the expected costs to complete.

6.8 SETTLEMENT DISCOUNTS ALLOWED

When a business allows settlement discounts they need to apply IFRS 15 *Revenue from Contracts with Customers* to determine the amount they record the sale at. When a business offers this type of discount they have variable consideration and they need to decide whether they expect their customer to take up the settlement discount.

6.8.1 ACCOUNTING FOR A SETTLEMENT DISCOUNT WHEN YOU EXPECT THE CUSTOMER TO TAKE UP THE OFFER

The sale will initially be recorded net of the settlement discount as this is the amount they expect to receive as revenue. For example, Company S sells goods on credit to Company T for $100 and they offer a 5 per cent discount for paying early. Company S expect Company T to pay early. Company S will record the sale at $95, as they only expect to receive 95 per cent of the amount invoiced. This will be recorded as follows:

		$	$
Dr.	Trade receivables control account	95	
Cr.	Sales		95

Company S then receives $95 as Company T pays early and this will be recorded as follows:

		$	$
Dr.	Cash	95	
Cr.	Trade receivables control account		95

If the customer pays late they will not be entitled to the settlement discount and Company S will receive $100. The $5 will be recorded as additional revenue as follows:

		$	$
Dr.	Cash	100	
Cr.	Trade receivables control account		95
Cr.	Sales		5

Worked Example: Settlement discounts when the customer is expected to take up the settlement discount

Mumble Company sells some goods on credit to a customer for $4000. Their credit terms are 30 days but Mumble Company offers the customer a 10 per cent discount if they pay within 10 days. Mumble Company expects the customer to pay within the 10 days.

Mumble Company has variable consideration, they have made a sale for $4000 but they could just receive $3600 ($4000 × 90%). Mumble Company should record revenue at $3600 as the question tells you this is the amount they expect to receive.

		$	$
Dr.	Sales	3600	
Cr.	Trade receivables control account		3600

The customer pays within 10 days so Mumble Company will receive the $3600 and this will fully pay off the trade receivable.

		$	$
Dr.	Cash	3600	
Cr.	Trade receivables control account		3600

MODULE 4

Question 6. Settlement discounts

On 1 May 20X7 Freddie sells some football merchandise to a customer on credit for $6000, and he offers the customer a settlement discount of 10 per cent if they pay within 10 days. In the past the customer has always taken up the settlement discount and Freddie expects this to continue. The customer pays the full amount on the 16 May 20X7.

Required

(a) Prepare the initial entry to record the sale on 1 May 20X7.

(b) Prepare the entry to record the cash receipt on 16 May 20X7.

(The answer is at the end of the module.)

6.8.2 ACCOUNTING FOR A SETTLEMENT DISCOUNT WHEN YOU DO NOT EXPECT THE CUSTOMER TO TAKE UP THE OFFER

The settlement discount will be ignored and the sale will initially be recorded at the full amount as this is the amount they expect to receive as revenue. For example, Company X sells goods on credit to Company Y for $500 and they offer a 5 per cent discount for paying early. Company X do not expect Company Y to pay early so they will record the sale at $500. This will be recorded as follows:

		$	$
Dr.	Trade receivables control account	500	
Cr.	Sales		500

If Company X receives $500 as the customer does not pay early, this will be recorded as follows:

		$	$
Dr.	Cash	500	
Cr.	Trade receivables control account		500

If the customer pays early they could still take up the settlement discount and Company X will receive $475 ($500 × 95%). The cash received is recorded as follows:

		$	$
Dr.	Cash	475	
Cr.	Trade receivables control account		475

Then Company X will need to account for the settlement discount as they had not expected the customer to take this up. This is done by adjusting the sale as follows:

		$	$
Dr.	Sales	25	
Cr.	Trade receivables control account		25

Worked Example: Settlement discount when the customer is not expected to take up the discount.

Company M sells goods to Company T at a price of $5000 and they offer a 10 per cent discount for paying within 10 days. Company M does not expect Company T to take up the discount.

Company M should record the initial sale at $5000 as that is the amount they expect to receive. This will be recorded as follows:

		$	$
Dr.	Sales	5000	
Cr.	Trade receivables control account		5000

Company T pays after the 10 days so Company Twill receive $5000 which will recorded as follows:

		$	$
Dr.	Cash	5000	
Cr.	Trade receivables control account		5000

6.9 DISCLOSURE

The objective is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The following amounts should be disclosed unless they have been presented separately in the financial statements in accordance with other standards.

- Revenue recognised from contracts with customers, disclosed separately from other sources of revenue.
- Any impairment losses recognised (in accordance with IFRS 9) on any receivables or contract assets arising from an entity's contracts with customers, disclosed separately from other impairment losses.
- The opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers.
- Revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period.
- Revenue recognised in the reporting period from performance obligations satisfied in previous periods (such as changes in transaction price).

Other information that should be provided:

- An explanation of significant changes in the contract asset and liability balances during the reporting period.
- Information regarding the entity's performance obligations, including when they are typically satisfied (upon delivery, upon shipment, as services are rendered etc.), significant payment terms (such as when payment is typically due) and details of any agency transactions, obligations for returns or refunds and warranties granted.
- The aggregate amount of the transaction price allocated to the performance obligations that are not fully satisfied at the end of the reporting period and an explanation of when the entity expects to recognise these amounts as revenue.
- Judgements, and changes in judgements, made in applying the standard that significantly affect the determination of the amount and timing of revenue from contracts with customers.
- Assets recognised from the costs to obtain or fulfil a contract with a customer. This would include pre-contract costs and set-up costs. The method of amortisation should also be disclosed.

Question 7: Recognition of revenue for a cleaning company

On 1 January 20X1 a cleaning company agrees to provide cleaning services for a customer over a period of two years for a total price of $15 000. The customer agrees to make an upfront payment of $10 000 and the remaining $5000 is payable at the start of the second year.

Required

Explain, with calculations the amount of revenue the business should recognise for the year ended 31 December 20X1.

(The answer is at the end of the module.)

Question 8: Recognition of revenue for an airline

An airline books a flight in September 20X6. The passenger will pay in October 20X6, depart in January 20X7 and return in March 20X7.

Required

Discuss when the airline should recognise revenue.

(The answer is at the end of the module.)

7 CURRENT TAX

LO 4.3

Section overview

- Current tax is the amount payable to the tax authorities in relation to the trading activities of the period.

7.1 IAS 12 *INCOME TAXES*

IAS 12 covers both current and deferred tax. The parts relating to current tax are fairly brief, because this is the simple and uncontroversial area of tax.

7.2 DEFINITIONS

These are some of the definitions given in IAS 12. We will look at the rest later.

Definitions

Accounting profit. Net profit or loss for a period before deducting tax expense.

Taxable profit (tax loss). The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Tax expense (tax income). The aggregate amount included in the determination of profit before tax or loss for the period in respect of current tax and deferred tax.

Current tax. The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. *(IAS 12)*

Before we go any further, let us be clear about the difference between current and deferred tax.

(a) **Current tax** is the estimated amount **payable** to the tax authorities in relation to the trading activities of the entity during the period.

(b) **Deferred tax** is an **accounting measure**, representing the future tax consequences of past transactions and events.

You will understand this after working through Sections 7 and 8.

7.3 RECOGNITION OF CURRENT TAX LIABILITIES AND ASSETS

IAS 12 requires any **unpaid tax** in respect of the current period to be **charged (expensed) to profit or loss** and recognised as a **liability**:

Dr. Tax expense (profit or loss)

Cr. Tax liability (statement of financial position)

This liability is normally estimated at the year end, and settled a number of months later, in the next accounting period. Often the tax actually paid differs from the liability recorded.

Where the liability estimated at a period end is greater than the tax later paid, the balance remaining on the tax liability account is termed an overprovision. This is deducted from the following year's tax charge (expense).

Where the liability estimated at a period end is less than the tax later paid, the balance remaining on the tax liability account is termed an underprovision. The following year's tax charge (expense) is increased by this amount.

Therefore, the charge (expense) to profit or loss shown in the statement of profit or loss and other comprehensive income in relation to current tax is calculated as:

Estimated tax charge for the current year	X
Under/(over) provision relating to the previous year	X/(X)
	X

IAS 12 refers to overprovisions and underprovisions as **adjustments for current tax of prior periods**.

Question 9: Current tax

In 20X8 Darton Co. had taxable profits of $120 000. In the previous year (20X7) income tax on 20X7 profits had been estimated as $30 000.

Required

Calculate tax payable and the charge for 20X8 (at a rate of 30 per cent) if the tax due on 20X7 profits was subsequently paid to the tax authorities as:

(a) $35 000; or

(b) $25 000.

(The answer is at the end of the module.)

Taking this a stage further, IAS 12 also requires recognition (as an asset) of the benefit relating to any tax loss that can be **carried back** to recover current tax of a previous period. This is acceptable because it is probable that the benefit will flow to the entity **and** it can be reliably measured.

Worked Example: Tax losses carried back

In 20X7 Eramu Co. paid $50 000 in tax on its profits. In 20X8 the company made tax losses of $24 000. The local tax authority rules allow losses to be carried back to offset against current tax of prior years.

Required

Show the tax expense and tax liability for 20X8.

Solution

Tax repayment due on tax losses = 30% × $24 000 = $7200.

The double entry will be:		$	$
Dr.	Tax receivable (statement of financial position)	7200	
Cr.	Tax repayment (profit or loss)		7200

The tax receivable will be shown as an asset until the repayment is received from the tax authorities.

7.4 MEASUREMENT

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. They are measured at the **amount expected to be paid to (recovered from) the tax authorities**. The tax rates (and tax laws) used should be those enacted (or substantively enacted) by the end of the reporting period.

7.5 RECOGNITION OF CURRENT TAX

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period, except in two cases:

(a) Tax arising from a **business combination** is treated differently. (Tax assets or liabilities of the acquired subsidiary will form part of the goodwill calculation. See Module 5.)

(b) Tax arising from a transaction or event which is recognised **directly in equity or as other comprehensive income** (in the same or a different period).

The rule in (b) is logical. If a transaction or event is charged or credited directly to equity, or as other comprehensive income rather than to profit or loss, then the related tax should be also. An example of such a situation is where, under IAS 8, an adjustment is made to the **opening balance of retained earnings** due to either a change in accounting policy that is applied retrospectively, or to the correction of a material prior period error (see Module 1).

7.6 PRESENTATION

In the statement of financial position, **tax assets and liabilities** are shown separately from other assets and liabilities.

Current tax assets and liabilities can be **offset**, but only when certain conditions apply:

- the entity has a **legally enforceable right** to set off the recognised amounts; and
- the entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

The **tax expense (income)** related to the profit or loss from ordinary activities is shown in the statement of profit or loss and other comprehensive income.

8 DEFERRED TAX

LO 4.3

Section overview

- Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact.

8.1 WHAT IS DEFERRED TAX?

When a company recognises an asset or liability, it expects to **recover or settle the carrying amount** of that asset or liability. In other words, it expects to sell or use up assets, and to pay off liabilities. What happens if that recovery or settlement is likely to make future tax payments larger (or smaller) than they would otherwise have been if the recovery or settlement had no tax consequences? In these circumstances, IAS 12 requires companies to recognise a **deferred tax liability** (or **deferred tax asset**).

8.2 DEFINITIONS

Don't worry too much if you don't understand the concept of deferred tax yet; things should become clearer as you work through this section. First of all, here are the definitions relating to deferred tax given in IAS 12.

Definitions

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences;
- the carry forward of unused tax losses; and
- the carry forward of unused tax credits.

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences may be either:

- **Taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
- **Deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

A taxable temporary difference gives rise to a **deferred tax liability**. A deductible temporary difference may give rise to a **deferred tax asset**.

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

(IAS 12)

We need to discuss some of these definitions in more detail.

8.3 TAX BASE

We can expand on the definition given above by stating that the **tax base of an asset** is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount.

Essentially this is the valuation of the asset or liability under tax rules rather than accounting rules. For example, the tax base of a non-current asset would be its tax written down value (cost less tax/capital allowances) as opposed to its carrying value (cost less accumulated depreciation).

Question 10: Tax base assets

State the tax base of each of the following assets:

(a) A machine cost $10 000. For tax purposes, depreciation of $3000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.

(b) Interest receivable has a carrying amount of $1000. The related interest revenue will be taxed on a cash basis.

(c) Trade receivables have a carrying amount of $10 000. The related revenue has already been included in taxable profit (tax loss).

(d) A loan receivable has a carrying amount of $1m. The repayment of the loan will have no tax consequences.

(The answer is at the end of the module.)

In the case of a **liability**, the tax base will be its carrying amount, less any amount that will be deducted for tax purposes in relation to the liability in future periods. For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will **not** be taxable in future periods.

Question 11: Tax base liabilities

State the tax base of each of the following liabilities.

(a) Current liabilities include accrued expenses with a carrying amount of $1000. The related expense will be deducted for tax purposes on a cash basis.

(b) Current liabilities include interest revenue received in advance, with a carrying amount of $10 000. The related interest revenue was taxed on a cash basis.

(c) Current liabilities include accrued expenses with a carrying amount of $2000. The related expense has already been deducted for tax purposes.

(d) Current liabilities include accrued fines and penalties with a carrying amount of $100. Fines and penalties are not deductible for tax purposes.

(e) A loan payable has a carrying amount of $1m. The repayment of the loan will have no tax consequences.

(The answer is at the end of the module.)

IAS 12 gives the following examples of circumstances in which the carrying amount of an asset or liability will be **equal to its tax base**.

- **Accrued expenses** which have already been deducted in determining an entity's current tax liability for the current or earlier periods.
- A **loan payable** is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- **Accrued expenses** which will never be deductible for tax purposes.
- **Accrued income** which will never be taxable.

8.4 TEMPORARY DIFFERENCES

You may have found the definition of temporary differences somewhat confusing. Remember that accounting profits form the basis for computing **taxable profits**, on which the tax liability for the year is calculated; however, accounting profits and taxable profits are different. There are two reasons for the differences:

- **Permanent differences**. These occur when certain items of revenue or expense are excluded from the computation of taxable profits (for example, client entertainment expenses may not be allowable for tax purposes).
- **Temporary differences**. These occur when items of revenue or expense are included in both accounting profits and taxable profits, but not for the same accounting period. For example, an expense which is allowable as a deduction in arriving at taxable profits for 20X7 might not be included in the financial accounts until 20X8 or later.

In the long run, the total taxable profits and total accounting profits will be the same (except for permanent differences) as temporary differences originate in one period and are capable of reversal in one or more subsequent periods. Deferred tax is the tax attributable to **temporary differences**.

Temporary differences may be taxable or deductible. Taxable temporary differences are considered in section 9 of this module and deductible temporary differences in section 10.

8.5 SECTION SUMMARY

- Deferred tax is an **accounting device**. It does **not** represent tax payable to the tax authorities.
- The **tax base** of an asset or liability is the value of that asset or liability for tax purposes.
- You should understand the difference between **permanent and temporary differences**.
- Deferred tax is the tax attributable to **temporary differences**.

9 TAXABLE TEMPORARY DIFFERENCES

LO 4.3

Section overview

- A taxable temporary difference results in a deferred tax liability.

9.1 CALCULATION OF A TAXABLE TEMPORARY DIFFERENCE AND ASSOCIATED LIABILITY

A taxable temporary difference arises where the **carrying amount of an asset exceeds its tax base**, or the **carrying amount of a liability is less than its tax base** and is calculated as the difference between the carrying amount and the tax base.

The resultant deferred tax liability is calculated by applying the relevant tax rate to the taxable temporary difference.

9.2 EXAMPLES OF TAXABLE TEMPORARY DIFFERENCES

Common transactions which result in taxable temporary differences include the following:

- **Interest revenue** received in arrears and included in accounting profit on the basis of time apportionment. It is included in taxable profit, however, on a cash basis i.e. when it is received.
- **Depreciation** of an asset is accelerated for tax purposes. When new assets are purchased, allowances may be available against taxable profits which exceed the amount of depreciation chargeable on the assets in the financial accounts for the year of purchase.
- **Development costs** which have been capitalised will be amortised through profit or loss, but they were deducted in full from taxable profit in the period in which they were incurred.
- **Prepaid expenses** have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

Exam comments

For the purposes of the exam, ensure you understand taxable temporary differences relating to non-current assets, sometimes referred to as accelerated capital allowances.

Worked Example: Taxable temporary differences

A company purchased an asset costing $1500. At the end of 20X8 the carrying amount is $1000. The cumulative depreciation for tax purposes (capital allowances) is $900 and the current tax rate is 25 per cent.

Required

Calculate the deferred tax liability for the asset.

Solution

First, what is the tax base of the asset? It is $1500 – $900 = $600.

The carrying amount is given as $1000.

Therefore, the taxable temporary difference is $400 and a deferred tax liability is calculated as $400 × 25% = $100.

The rationale behind this is: to recover the carrying amount of $1000, the entity must earn taxable income of $1000, but it will only be able to deduct $600 as a taxable expense. The entity must therefore pay income tax of $400 × 25% = $100 when the carrying amount of the asset is recovered.

9.3 REVALUED ASSETS

Under IAS 16 assets can be revalued. The revaluation is recognised in other comprehensive income rather than profit. Therefore, the tax base of the asset remains unchanged.

The carrying amount will, however, increase to reflect the revalued amount. Therefore, on revaluation the taxable temporary difference relating to the asset increases and there is a deferred tax effect.

The additional deferred tax liability at the date of the revaluation is calculated as:

Revaluation surplus × tax rate

Question 12: Current and deferred tax

Jonquil Co. buys equipment in 20X1 for $50 000 and depreciates it on a straight-line basis over its expected useful life of five years. The equipment has no residual value. For tax purposes, the equipment is depreciated at 25 per cent per annum on a straight-line basis. Tax losses may be carried back against taxable profit of the previous five years. In year 20X0, the entity's taxable profit was $25 000. The tax rate is 40 per cent.

Required

Assuming nil profits/losses after depreciation in years 20X1 to 20X5 show the current and deferred tax impact in years 20X1 to 20X5 of the acquisition of the equipment.

(The answer is at the end of the module.)

10 DEDUCTIBLE TEMPORARY DIFFERENCES

LO 4.3

Section overview

- A deductible temporary difference results in a deferred tax asset.

10.1 CALCULATION OF A DEDUCTIBLE TEMPORARY DIFFERENCE AND ASSOCIATED ASSET

A deductible temporary difference arises where the **tax base of an asset exceeds its carrying amount** or the **tax base of a liability is less than its carrying amount**, and is calculated as the difference between the tax base and the carrying amount.

The resultant deferred tax asset is calculated by applying the relevant tax rate to the deductible temporary difference.

The deferred tax asset must also satisfy the **recognition criteria** given in IAS 12. This is that a deferred tax asset should be recognised for all deductible temporary differences to the extent that it is **probable that taxable profit will be available** against which it can be utilised.

10.2 EXAMPLES OF DEDUCTIBLE TEMPORARY DIFFERENCES

Common transactions which result in deductible temporary differences include, but are not limited to, the following:

- **Retirement benefit costs** (pension costs) are deducted from accounting profit as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)
- The **NRV** of inventory, or the **recoverable amount** of an item of property, plant and equipment falls and the carrying amount is therefore **reduced**, but that reduction is ignored for tax purposes until the asset is sold.
- **Research costs** (or organisation/other start-up costs) are recognised as an expense for accounting purposes, but are not deductible against taxable profits until a later period.
- Income is **deferred** in the statement of financial position, but has already been included in taxable profit in current/prior periods.
- **Tax losses** arise which are carried forward against future taxable profits.

Exam comments

For the purposes of the exam, ensure you understand deductible temporary differences relating to tax losses and expenses recognised in profit or loss before they are paid.

Worked Example: Deductible temporary differences

Pargatha Co. recognises a liability of $10 000 for accrued product warranty costs on 31 December 20X7. These product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 25 per cent.

Required

State the deferred tax implications of this situation.

Solution

The tax base of the liability is nil (carrying amount of $10 000 less the amount that will be deductible for tax purposes in respect of the liability in future periods).

The carrying amount of the liability is $10 000.

Therefore, there is a deductible temporary difference of $10 000 and a deferred tax asset of $2500 arises ($10 000 × 25%) **provided that** it is probable that the entity will earn sufficient taxable profits in future periods to benefit from a reduction in tax payments.

The rationale behind this is: when the liability is settled for its carrying amount, the entity's future taxable profit will be reduced by $10 000 and so its future tax payments fall by $10 000 × 25% = $2500.

10.3 TAXABLE PROFITS IN FUTURE PERIODS

When can we be sure that sufficient taxable profit will be available against which a deductible temporary difference can be utilised? IAS 12 states that this will be assumed when sufficient **taxable temporary differences** exist which relate to the same taxation authority and the same taxable entity. These should be expected to reverse:

- in the same period as the expected reversal of the deductible temporary difference; **or**
- in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

In these circumstances the deferred tax asset is **recognised** in the period in which the deductible temporary differences arise.

10.4 UNUSED TAX LOSSES AND UNUSED TAX CREDITS

An entity may have unused tax losses (i.e. which it can offset against taxable profits) at the end of a period. These losses are not recognised in the statement of financial position and so have nil carrying amount. Their tax base is the amount that can be deducted from taxable profits in the future i.e. the amount of the loss. Therefore, a deferred tax asset potentially arises, although IAS 12 states that it may only be recognised **to the extent that it is probable that future taxable profit will be available against which the unused tax losses/credits can be utilised**.

The amount of the deferred tax asset is calculated as: Recoverable tax losses c/f × tax rate

11 MEASUREMENT AND RECOGNITION OF DEFERRED TAX

LO 4.3

Section overview

- IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply when the asset is realised or the liability settled.

11.1 CHANGES IN TAX RATES

Where the corporate rate of income tax **fluctuates from one year to another**, a problem arises in respect of the amount of deferred tax to be credited (debited) to the statement of profit or loss and other comprehensive income in later years.

IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply in the period **when the asset is realised or liability settled**, based on tax rates and laws enacted (or substantively enacted) at the end of the reporting period.

11.2 DEFERRED TAX ASSETS AND LIABILITIES ARE NOT DISCOUNTED

Discounting is used to allow for the effect of the time value of money.

IAS 12 states that deferred tax assets and liabilities **are not discounted** because of the complexities and difficulties involved. Discounting is applied to other non-current liabilities such as provisions and deferred payments.

11.3 CARRYING AMOUNT OF DEFERRED TAX ASSETS

The carrying amounts of deferred tax assets are **reviewed at the end of each reporting period** and reduced where appropriate (insufficient future taxable profits). Such a reduction may be reversed in future years.

11.4 RECOGNITION

Deferred tax (and current tax) is recognised as income or expense and included in the **net profit or loss for the period**, unless the tax arises from a transaction or event which is recognised as **other comprehensive income or directly in equity in which case the** tax is **charged or credited to other comprehensive income or directly to equity.**

Examples of IFRSs which allow items to be credited or charged to other comprehensive income or directly to equity include:

- **revaluations** of property, plant and equipment (IAS 16) – credited to other comprehensive income; and
- the effect of a **change in accounting policy** (applied retrospectively) or correction of a **material error** (IAS 8) – credited or charged directly to equity.

Worked Example: Recognition

Z Co. owns a property which has a carrying amount at the beginning of 20X9 of $1 500 000. At the year end it has revalued the property to $1 800 000. The tax rate is 30 per cent. How will this be shown in the financial statements?

Solution

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	$'000
Profit for the year	X
Other comprehensive income:	
Gains on property revaluation	300
Income tax relating to components of other comprehensive income (300 × 30%)	(90)
Other comprehensive income for the year net of tax	210

The amounts will be posted as follows:

	Dr. $'000	*Cr.* $'000
Property, plant and equipment	300	
Deferred tax		90
Revaluation surplus		210

11.5 WHY DO WE RECOGNISE DEFERRED TAX?

- Adjustments for deferred tax are made in accordance with the **accruals concept** and in accordance with the definition of a **liability** in the *Conceptual Framework*, i.e. a past event has given rise to an obligation in the form of increased taxation which will be payable in the future and the amount can be reliably estimated. A deferred tax asset similarly meets the definition of an **asset**.
- If the future tax consequences of transactions are not recognised, profit can be overstated, leading to overpayment of dividends and distortion of share price and earnings per share.

12 TAXATION IN COMPANY ACCOUNTS

LO 4.3

Section overview

- In the statement of financial position the liability for tax payable is the tax owing for the year. The deferred tax balance will also be included as a liability or (more unusually) asset. In the statement of profit or loss and other comprehensive income the tax charge for the year is adjusted for transfers to or from deferred tax and for prior year under or over-provisions.

Tax affects three figures in company accounts.

- Taxation on profits in the statement of profit or loss and other comprehensive income.
- Taxation payments due, shown respectively as a current liability for current tax and a non-current liability for deferred tax, in the statement of financial position.

12.1 TAXATION IN THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

The tax charge (expense) for the year is calculated by **aggregating**:

- **income tax** on taxable profits;
- **transfers to or from deferred taxation**; and
- any **adjustments** (**under-provision or over-provision)** for current tax on profits of previous years.

Question 13: Tax payable

In the accounting year to 31 December 20X3, Neil Down Co. made an operating profit before taxation of $110 000.

Income tax on the operating profit has been estimated at $45 000. In the previous year (20X2) income tax on 20X2 profits had been estimated at $38 000 but it was subsequently agreed at $40 500.

A transfer to the credit of the deferred taxation account of $16 000 will be made in 20X3.

Required

(a) Calculate the tax on profits for 20X3 for in the statement of profit or loss and other comprehensive income.

(b) Calculate the amount of tax payable in the statement of financial position.

(The answer is at the end of the module.)

12.2 TAXATION IN THE STATEMENT OF FINANCIAL POSITION

The statement of financial position will include a current liability for the income tax owing at year end. This may not necessarily be the same amount as the income tax relating to the current year's profit, as there may have been over or under-provision in previous years.

There will usually also be a deferred tax liability, shown as a non-current liability. Sometimes, but rarely, there will be a deferred tax asset.

Question 14: Tax charge

For the year ended 31 July 20X4 Norman Kronkest Co. made taxable trading profits of $1 200 000 on which income tax is payable at 30 per cent.

- An amount of $20 000 will be credited to the deferred taxation account. The deferred tax liability brought forward at 1 August 20X3 was $100 000.
- The estimated tax on profits for the year ended 31 July 20X3 was $80 000, but tax has now been agreed at $84 000 and fully paid.
- Tax on profits for the year to 31 July 20X4 is payable on 1 May 20X5.

- In the year to 31 July 20X4 the company made a capital gain of $60 000 on the sale of some property. This gain is taxable at a rate of 30 per cent.

Required

(a) Calculate the tax charge for the year to 31 July 20X4.

(b) Calculate the tax liabilities in the statement of financial position of Norman Kronkest as at 31 July 20X4.

(The answer is at the end of the module.)

12.3 PRESENTATION OF TAX EXPENSE

The tax expense or income related to the profit or loss for the period should be disclosed as a line item in the statement of profit or loss and other comprehensive income.

KEY MODULE POINTS 2

- IFRS 15 provides the rules for the recognition of revenue based on transfer of control to the customer from the entity supplying the goods or services.
- IFRS 15 sets out a five-step model for the recognition of revenue.
- Revenue will be recognised at a point in time or over a period of time.
- Current tax is the amount payable to the tax authorities in relation to the trading activities of the period.
- Unpaid tax in respect of the current period is charged to profit or loss and recognised as a liability.
- Where the liability is less than the tax later paid, the balance remaining on the tax liability account is termed an under-provision. The following year's tax charge is increased by this amount.
- Where the liability is more than the tax later paid, the balance remaining on the tax liability account is an over-provision and the following year's tax charge is decreased by this amount.
- Deferred tax is an accounting measure, used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results.
- Deferred tax adjusts for the effects of temporary differences arising because the tax treatment of an item differs from its accounting treatment.
- A temporary difference is calculated by comparing the carrying amount of an asset or liability with its tax base.
- The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.
- If the carrying amount of an asset is greater than its tax base, this is a taxable temporary difference and results in a deferred tax liability.
- If the tax base of an asset is greater than its carrying amount, this is a deductible temporary difference and results in a deferred tax asset.
- If the carrying amount of a liability is greater than its tax base, this is a deductible temporary difference and results in a deferred tax asset.
- If the tax base of a liability is greater than its carrying amount, this is a taxable temporary difference and results in a deferred tax liability.
- Deferred tax assets and liabilities are measured at the tax rates expected to apply in the period when the asset is realised or liability settled, based on tax rates and laws enacted (or substantively enacted) at the end of the reporting period.
- Deferred tax should normally be recognised as income or an expense and included in the net profit or loss for the period.
- Deferred tax (and current tax) should be charged or credited to other comprehensive income or directly to equity if the tax relates to items also charged or credited to other comprehensive income or directly to equity (in the same or a different period).
- The tax charge for the year is calculated by aggregating:
  - income tax on taxable profits;
  - transfers to or from deferred taxation;
  - any adjustments (under-provision or over-provision) of current tax on profits of previous years.

QUICK REVISION QUESTIONS 2

1 On 31 March 20X7, DT received an order from a new customer, XX, for products with a sales value of $900 000. XX enclosed a deposit with the order of $90 000.

On 31 March 20X7, DT had not completed credit referencing of XX and had not despatched any goods. DT is considering the following possible entries for this transaction in its financial statements for the year ended 31 March 20X7.

I. recognise a liability for $90 000
II. include $90 000 in revenue for the year
III. include $900 000 in revenue for the year
IV. recognise a trade receivable for $810 000
V. do not include anything in revenue for the year

According to IFRS 15 *Revenue from Contracts with Customers*, how should DT record this transaction in its financial statements for the year ended 31 March 20X7?

A I and II only
B I and V only
C III and IV only
D IV and V only

2 London Co. sells air conditioning systems, providing one year's free servicing with every system sold. The servicing could be purchased separately for $500. How should London Co. account for the $4000 sales price of each system?

A $4000 should be recognised as revenue spread over the first year after sale.
B $4000 should be recognised as revenue when each system is delivered to the customer.
C $3560 should be recognised as revenue when each system is delivered to the customer and $440 should be spread over the first year of sale.
D $4000 should be recognised as revenue when each system is delivered to the customer and $500 recognised as revenue over the first year after sale.

3 Which of the following statements regarding revenue recognition are correct?

I. Revenue should ignore any settlement discounts.
II. Tuition fees received by a college are recognised as income on the day the tuition commences.
III. Revenue from the sale of goods on a sale or return basis is recognised when the goods are sold to a third party.

A I only
B III only
C II and III only
D I, II and III

4 Leo Co. is liable to corporate income tax at a rate of 30 per cent. The following information is relevant:

Y/e 30 November 20X7

Profit before tax	$490 000
Taxable profits	$502 000
Tax paid in 20X8 in respect of year	$149 000

Y/e 30 November 20X8

Profit before tax	$523 000
Taxable profits	$582 000
Tax paid in 20X9 in respect of year	$170 000

What is the tax charge in the statement of profit or loss and other comprehensive income for the year ended 30 November 20X8?

A $158 900
B $170 000
C $173 000
D $174 600

5 At 30 September 20X2 the statement of financial position of CBN Co. included a liability for deferred tax of $128 500. At 30 September 20X3 the non-current assets had a carrying amount of $2 650 000 and a tax written down value of $1 872 000. The tax rate is 20 per cent.

What is the balance on the deferred tax account at 30 September 20X3?

A $27 100
B $128 500
C $155 600
D $778 000

6 A company in its first year of trading has significantly higher capital allowances (tax depreciation) than the accounting depreciation charged to profit or loss on the same assets. What would be the effect of recognising a liability for deferred taxation in respect of these assets?

	Profit after tax	Net assets
A	increase	increase
B	decrease	increase
C	increase	decrease
D	decrease	decrease

7 At 30 November 20X4 the carrying amount of the non-current assets of Reynard Co. was $3 570 000 and the tax written down value was $2 450 000. The liability for deferred tax brought forward was $250 000.

The tax rate is 22 per cent.

What should be reported in the statement of profit or loss and other comprehensive income in respect of deferred tax?

A a credit of $3600
B a charge of $3600
C a credit of $246 400
D a charge of $246 400

8 At 30 April 20X6, the carrying amount of the non-current assets of Bahno Co. was $80 000 greater than the tax written down value, and the balance brought forward on the deferred tax account was $24 800. The company accountant calculated that the income tax charge on the reported profit for the year to 30 April 20X6 would be $53 960, based on the tax rate of 24 per cent.

What is the total charge for taxation in the statement of profit or loss and other comprehensive income for the year to 30 April 20X6?

A $48 360
B $59 560
C $73 160
D $78 760

9 Which of the following statements about deferred taxation is correct?

A Deferred tax is an amount of tax certain to be payable at a future date.
B Deferred taxation is an accounting item used to apply the accruals concept to taxation charges in the accounts.
C Deferred taxation is an accounting item used to apply the consistency concept to taxation charges in the accounts.
D Deferred tax liabilities are shown in the statement of financial position of a company as part of the taxation current liability.

10 Kelt Co. makes a tax-adjusted loss in its 20X8 financial year of $320 000. $120 000 of these losses are carried back to relieve against the profits of 20X7 and $15 000 are used in the current year to relieve other income. The remainder are carried forward. In 20X9 Kelt Co. is expected to make significant profits as a result of the launch of a new product. Kelt Co.'s tax rate is 25 per cent.

What is the deferred tax implication, if any, in 20X8 of the loss made?

A A deferred tax asset of $46 250
B A deferred tax asset of $50 000
C A deferred tax liability of $46 250
D A deferred tax liability of $50 000

11 Which of the following statements are correct?

I. A deferred tax liability is the result of a deductible temporary difference.
II. The tax base of an asset is the future amount which is deductible from profits.
III. A revaluation will result in the recognition of a deferred tax movement in profit or loss.
IV. Where the carrying amount of an asset exceeds its tax base there will be a taxable temporary difference.

A I and IV only
B II and III only
C II and IV only
D I, II, III and IV

12 Parker Co. has non-current assets with an original cost of $580 000. As at 31 January 20X9, accumulated depreciation provided on these assets amounts to $80 000 and tax allowances given amount to $130 000. On this date, Parker recognised a $100 000 revaluation surplus in respect of a factory included within the above. The original cost of the factory was $190 000, accumulated depreciation to date was $20 000 and tax allowances $30 000. Parker's tax rate is 20 per cent and the deferred tax liability brought forward in respect of accelerated capital allowances was $9000.

How are movements in deferred tax recognised in the statement of profit or loss and other comprehensive income?

	In profit or loss	As other comprehensive income
A	$1000 charge	$20 000 charge
B	$1000 credit	$22 000 charge
C	$8000 credit	$22 000 charge
D	$10 000 charge	$20 000 charge

13 Extracts from the financial statements of Rasputin Co. are as follows:

Tax charge to profits	$47 500
Company income tax liability for the year	$56 000
Deferred tax liability at start of year	$34 000
Deferred tax liability at end of year	$28 000

Rasputin has always paid its tax due on time. What is the under or over-provision relating to the previous year?

A $2500 over-provision
B $2500 under-provision
C $14 500 over-provision
D $14 500 under-provision

13 FOREIGN CURRENCY

LO 4.4

Section overview

- IAS 21 deals with converting individual transactions into local currency before recording them. It also deals with translating a foreign subsidiary's financial statements before consolidating them.

IAS 21 *The Effects of Changes in Foreign Exchange Rates* recognises that there are two main instances in which foreign currency amounts must be translated into another currency:

1. If a company trades overseas, it will buy or sell assets in foreign currencies. For example, an Indian company might buy materials from Canada, and pay for them in US dollars, and then sell its finished goods in Germany, receiving payment in Euro, or perhaps in some other currency. These transactions must be translated into the functional currency of the Indian company before they can be recorded in its financial statements.
2. A company might have a subsidiary abroad (i.e. a foreign entity that it owns), and the subsidiary will trade in its own local currency. The subsidiary will keep the financial records and prepare its annual accounts in its own currency. At the year end, the parent company must 'consolidate' the results of the overseas subsidiary into its group financial statements. Before this can happen, the financial statements of the subsidiary must be translated into the currency in which the group accounts are prepared.

13.1 DEFINITIONS

These are some of the definitions given by IAS 21.

Definitions

Foreign currency. A currency other than the functional currency of the entity.

Functional currency. The currency of the primary economic environment in which the entity operates.

Presentation currency. The currency in which the financial statements are presented.

Exchange rate. The ratio of exchange for two currencies.

Exchange difference. The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Closing rate. The spot exchange rate at the end of the reporting period.

Spot exchange rate. The exchange rate for immediate delivery. *(IAS 21)*

Each entity – whether an individual company, a parent of a group, or an operation within a group (such as a subsidiary, associate or branch) – should determine its **functional currency** and **measure its results and financial position in that currency**.

For most individual companies the functional currency is the currency of the country in which they are located and in which they carry out most of their transactions. Determining the functional currency is much more likely to be an issue where an entity operates as part of a group. IAS 21 contains detailed guidance on how to determine an entity's functional currency and we will look at this in more detail in section 15.

An entity can present its financial statements in any currency (or currencies) it chooses. IAS 21 deals with the situation in which financial statements are presented in a currency other than the functional currency. Again, this is unlikely to be an issue for most individual companies. Their presentation currency is normally the same as their functional currency (the currency of the country in which they operate).

14 FOREIGN CURRENCY TRANSACTIONS

LO 4.4

Section overview

- Foreign currency transactions must be translated into the presentation currency of an entity before they are recorded in the financial statements; monetary items remaining in the statement of financial position at the year end are re-translated using the closing rate.

14.1 FOREIGN CURRENCY TRANSACTIONS: INITIAL RECOGNITION

IAS 21 requires that foreign currency transactions are translated using the exchange rate at the date of the transaction (the spot rate) before they are recorded in the financial statements.

An **average rate** for a period may be used if exchange rates do not fluctuate significantly.

Worked Example: Initial recognition (1)

An Australian company with a 31 December year end buys a large consignment of goods from a supplier in Germany. The order is placed on 1 May and the agreed price is €124 250. At the time of delivery the rate of foreign exchange was €3.50 to $1. The Australian company would record the amount owed in its books as follows:

Dr.	Inventory (124 250 / 3.5)	$35 500	
Cr.	Payables		$35 500

14.2 SETTLEMENT BEFORE THE PERIOD END

Where a foreign currency amount payable or receivable is settled in the same period as that in which the transaction took place, an exchange difference will arise (assuming that the exchange rate has moved since the date of the transaction).

This is best explained by continuing the example above.

Worked Example: Initial recognition (2)

When the Australian company pays the supplier it needs to obtain some foreign currency. By this time, however, the rate of exchange has altered to €3.55 to $1, and the cost of raising €124 250 would be (/ 3.55) $35 000. The company needs to spend only $35 000 to settle a debt recorded at $35 500. As inventory is a non-monetary asset the value of the inventories is not amended in the company's financial records, instead we record a profit on conversion of $500.

Dr.	Payables	$35 500	
Cr.	Cash		$35 000
Cr.	Profit on conversion (exchange difference)		$500

The profit on conversion is recognised as part of the profit or loss for the year.

14.3 SETTLEMENT AFTER THE PERIOD END

14.3.1 AT THE PERIOD END

Where there is a foreign currency asset or liability in the statement of financial position at the year end, such as an unpaid supplier, the balance is re-translated using the closing (year end) exchange rate.

This is done for **monetary** assets and liabilities. Non-monetary assets and liabilities are not re-translated.

Definition

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Therefore, the following rules apply at each subsequent year end:

(a) Report foreign currency **monetary items** (such as receivables and payables) using the **closing rate**.

(b) Report **non-monetary items** (for example, non-current assets, inventories) that are carried at **historical cost** in a foreign currency using the **exchange rate that was used at the date of the transaction** (historical rate).

(c) Report **non-monetary items** that are carried at **fair value** in a foreign currency using the exchange rate that existed **when the values were determined**.

Exchange differences arising on the re-translation of monetary items are recognised as part of the profit or loss for the year.

14.3.2 SUBSEQUENT SETTLEMENT

When the monetary item is subsequently settled in the following period, any exchange difference resulting from a movement in the exchange rate between the previous period end and the date of settlement is recognised as part of the profit or loss for the year in which settlement takes place.

Question 15: Entries

White Cliffs Co., whose year end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40 000 and is due for settlement in equal instalments on 30 November and 31 January. The exchange rate moved as follows:

	€= $1
30 September	1.60
30 November	1.80
31 December	1.90
31 January	1.85

Required

State the accounting entries in the books of White Cliffs Co.

(The answer is at the end of the module.)

15 FOREIGN CURRENCY FINANCIAL STATEMENTS

LO 4.5

Section overview

- An entity will operate its business and record transactions in its functional currency. Where the entity is part of a group, the parent must translate its financial statements into the group presentation currency prior to consolidation.

A holding or parent company with foreign operations must **translate the financial statements** of those operations into its own reporting currency before they can be consolidated into the group accounts. There are two methods; **the method used depends** upon **whether** the foreign operation has the **same functional currency as the parent**.

15.1 DETERMINING FUNCTIONAL CURRENCY

IAS 21 states that an entity should consider the following factors in determining the functional currency of an entity:

- The currency that mainly **influences sales prices** for goods and services (often the currency in which prices are denominated and settled).

- The currency of the **country whose competitive forces and regulations** mainly determine the sales prices of its goods and services.
- The currency that mainly **influences labour, material and other costs** of providing goods or services (often the currency in which prices are denominated and settled).

Sometimes the functional currency of an entity is not immediately obvious. Management must then exercise judgment and may also need to consider:

- The currency in which **funds from financing activities** (raising loans and issuing equity) are generated.
- The currency in which **receipts from operating activities** are usually retained.

Where a parent has a foreign operation a number of factors are considered:

- Whether the activities of the foreign operation are carried out as an **extension of the parent**, rather than being carried out with a **significant degree of autonomy**.
- Whether **transactions with the parent** are a high or a low proportion of the foreign operation's activities.
- Whether **cash flows** from the activities of the foreign operation **directly affect the cash flows of the parent** and are readily available for remittance to it.
- Whether the activities of the foreign operation are **financed from its own cash flows** or by **borrowing from the parent**.

To sum up: to determine the functional currency of a foreign operation it is necessary to consider the **relationship** between the foreign operation and its parent:

- If the foreign operation carries out its business as though it were an **extension of the parent's operations**, it is likely to have the **same functional currency** as the parent.
- If the foreign operation is **semi-autonomous** it is likely to have **a different functional currency** from the parent.

The translation method used has to reflect the economic reality of the relationship between the reporting entity (the parent) and the foreign operation.

15.1.1 SAME FUNCTIONAL CURRENCY AS THE REPORTING ENTITY

In this situation, the foreign operation normally carries on its business as though it were an **extension of the reporting entity's operations**. For example, it may only sell goods imported from, and remit the proceeds directly to, the reporting entity.

Any **movement in the exchange rate** between the reporting currency and the foreign operation's currency will have an **immediate impact** on the reporting entity's cash flows from the foreign operations. In other words, changes in the exchange rate affect the **individual monetary items** held by the foreign operation, **not** the reporting entity's net investment in that operation.

Where a foreign operation has the same functional currency as its parent, it will almost certainly keep its accounting records in its functional currency, even if this is not the same as the local currency. This means that the financial statements of the foreign operation **do not need to be translated**.

In theory, the foreign operation could keep its accounting records and prepare individual financial statements in the local currency. In this situation, the foreign operation's transactions should be translated **as if they had been those of the parent**.

15.1.2 DIFFERENT FUNCTIONAL CURRENCY FROM THE REPORTING ENTITY

In this situation, although the reporting entity may be able to exercise control, the foreign operation normally operates in a **semi-autonomous** way. It accumulates cash and other monetary items, generates income and incurs expenses, and may also arrange borrowings, all **in its own local currency**.

A change in the exchange rate will produce **little or no direct effect on the present and future cash flows** from operations of either the foreign operation or the reporting entity. Rather, the change in exchange rate affects the reporting entity's **net investment** in the foreign operation, not the individual monetary and non-monetary items held by the foreign operation.

15.2 ACCOUNTING TREATMENT: DIFFERENT FUNCTIONAL CURRENCY FROM THE REPORTING ENTITY

The financial statements of the foreign operation must be translated to the functional currency of the parent. The functional currency of the parent is the **presentation currency** of the foreign operation.

- The **assets and liabilities** shown in the foreign operation's statement of financial position are translated at the **closing rate** at the reporting date, regardless of the date on which those items originated. Share capital and pre-acquisition reserves are translated at the historic rate being the exchange rate on the date of acquisition. Post-acquisition reserves are a balancing figure and include the exchange difference on translation. This is discussed in more detail in Section 15.3 below
- Amounts in the **statement of profit or loss** are translated at the rate ruling at the date of the transaction (an **average rate** will usually be used for practical purposes).

Worked Example: Different functional currency from the reporting entity

A dollar-based company, Stone Co., set up a foreign subsidiary on 30 June 20X7. Stone subscribed €24 000 for share capital when the exchange rate was €2 = $1. The subsidiary, Brick Inc., borrowed €72 000 and bought a non-monetary asset for €96 000. Stone Co. prepared its financial statements on 31 December 20X7 and by that time the exchange rate had moved to €3 = $1.

Required

Prepare Brick Inc's statement of financial position at 31 December 20X7 in both euros and dollars, and calculate the exchange gain or loss arising since 30 June 20X7.

Solution

Stone Co. will record its initial investment at $12 000 which is the cost of the shares. The statement of financial position of Brick Inc. at 31 December 20X7 is:

	€'000
Non-monetary asset	96
Share capital	24
Loan	72
	96

This is translated as:

	$'000
Non-monetary asset (€3 = $1)	32
Share capital and reserves* (retained earnings) (balancing figure)	8
Loan (€3 = $1)	24
	32
Exchange gain/(loss) for 20X7	(4)

- Shown as a single figure in this example for simplicity.
  The exchange loss is the difference between the value of the original investment ($12 000) and the net assets stated in the statement of financial position ($32 – $24).

Question 16: Translation of financial statements

The abridged statement of financial position and statement of profit or loss of Xerxes Inc., appear below:

DRAFT STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	Xerxes Inc.	
	€	€
Assets		
Non-current assets		
Plant at cost	500	
Less depreciation	(200)	
		300
		300
Current assets		
Inventories	200	
Receivables	100	
		300
		600
Equity and liabilities		
Equity		
Ordinary shares	100	
Reserves	280	
		380
Long-term loans		110
Current liabilities		110
		600

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X9

	Xerxes Inc.
	€
Profit before tax	300
Tax	(140)
Profit after tax, retained	160

The following further information is given:

(a) Darius Co. has owned shares in Xerxes Inc. since 1 January 20X9. On that date the company had reserves of €120.

(b) Exchange rates: €1.8 to $1 on 1 January 20X9
€1.6 to $1 average rate of exchange year ending 31 December 20X9
€1 to $1 on 31 December 20X9.

Required

Translate the statement of financial position and statement of profit or loss of Xerxes Inc. into dollars.

(The answer is at the end of the module.)

15.3 ANALYSIS OF EXCHANGE DIFFERENCES

In question 15 above, the exchange difference arising on translation of Xerxes' financial statements was included within post-acquisition reserves in the statement of financial position – although you would not necessarily have considered this as you completed the question.

The correct presentation of the exchange difference is as an item of other comprehensive income in the year which is then transferred to post-acquisition reserves. If you are asked to prepare a statement

of profit or loss and other comprehensive income, you may need to calculate the amount of the exchange difference. It consists of exchange gains or losses arising from:

(a) translating **income or expense items** at the average rate, whereas **assets or liabilities** are translated at the closing rate

(b) translating the **opening net investment** (opening net assets) in the foreign entity at a closing rate different from the closing rate at which it was previously reported.

This can be demonstrated using Xerxes:

Using the opening statement of financial position and translating at €1.8 = $1 and €1 = $1 gives the following:

	€	€1.8 = $1 $	€1 = $1 $	Difference $
Opening net assets				
Share capital	100			
Reserves (pre-acquisition since acquisition was at start of year)	120			
	220	122	220	98 gain

This is a gain because net assets worth $122 based on the opening exchange rate are now worth $220 based on the closing exchange rate.

Translating the statement of profit or loss using €1.60 = $1 and €1 = $1 gives the following results:

	€1.60 = $1 $	€1 = $1 $	Difference $
Profit of $100	100	160	60 gain

This is a gain because the reported profit of $100 based on the average exchange rate is worth $160 based on the closing exchange rate.

In the statement of profit or loss and other comprehensive income of Xerxes for the year ended 31 December 20X9, an exchange gain of $158 ($98 + $60) is recognised as other comprehensive income.

As we have said, the gain forms part of post-acquisition reserves and we can therefore analyse the post-acquisition reserves figure as:

	$
Profit since acquisition as reported in the translated statement of profit or loss (note that in this case the profit since acquisition is the profit for the year)	100
Exchange gain in total (98 + 60)	158
	258

16 DISCLOSURE REQUIREMENTS

LO 4.5

IAS 21 requires the following disclosures in respect of foreign currency transactions:

- the amount of exchange differences recognised in profit or loss in the period
- the amount of exchange differences recognised as other comprehensive income
- if relevant, the fact that the presentation currency is different from the functional currency and the reason why.

KEY MODULE POINTS 3

- IAS 21 deals with converting individual transactions into local currency before recording them. It also deals with translating a foreign subsidiary's financial statements before consolidating them.
- Individual foreign currency transactions are translated into the reporting currency of an entity before they are recorded in the financial statements.
- Foreign monetary items remaining in the statement of financial position at the reporting date are re-translated using the closing rate.
- Any exchange differences arising on re-translation or settlement are recognised in profit or loss.
- A foreign subsidiary will operate its business and record transactions in its functional currency. Where the entity is part of a group, the parent must translate its financial statements into the group presentation currency prior to consolidation.
- The assets and liabilities shown in the foreign operation's statement of financial position are translated at the closing rate at the reporting date, regardless of the date on which those items originated.
- Share capital and pre-acquisition reserves are translated at the historic rate being the exchange rate on the date of acquisition.
- Post-acquisition reserves are a balancing figure and include the exchange difference on translation.
- Amounts in the statement of profit or loss are translated at the spot rate at the date of the transaction (an average rate for the year will usually be applied to all amounts for practical purposes).
- The exchange difference arising on translation is calculated as the difference between:
  - opening net assets at the opening rate and opening net assets at the closing rate; plus
  - retained profits at the average rate and retained profits at the closing rate.

  It is recognised as other comprehensive income and forms part of post-acquisition reserves in the statement of financial position.

QUICK REVISION QUESTIONS 3

1 Which of the following statements, in respect of foreign currency translation, are correct according to IAS 21 *The Effects of Changes in Foreign Exchange Rates*?

I. The functional currency of an entity is selected by management
II. The presentation currency of an entity is selected by management
III. The functional currency of an entity is identified by reference to the circumstances of the business
IV. The presentation currency of an entity is identified by reference to the circumstances of the business

A I and II only
B I and IV only
C II and III only
D III and IV only

2 BLX Co. holds several investments in subsidiaries. One of these, CMY Co., is located abroad. CMY Co. prepares its financial statements in its local currency, the crown.

Several years ago, when the exchange rate was 5 crowns = $1, CMY Co. purchased land at a cost of 170 000 crowns. On 1 June 20X5, when the exchange rate was 6.5 crowns = $1 the land was revalued at a fair value of 600 000 crowns. The exchange rate at the group's year end, 31 December 20X5, was 7 crowns = $1.

In accordance with the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*, at what value in $ should the land be recognised in BLX Co.'s group financial statements at 31 December 20X5?

A $85 714
B $90 440
C $100 154
D $120 000

3 Street Co. purchased goods for €450 000 from an overseas supplier on 30 November 20X6. Street Co. paid for the goods on 31 January 20X7. They were not sold to third parties until February 20X7.

Exchange rates were:

	€=$1
30 November 20X6	1.5
31 December 20X6	1.45
31 January 20X7	1.55

What is the exchange difference that should be reported in profit or loss for the year ended 31 December 20X6 and at what amount should the goods be included in inventory in the statement of financial position at that date?

	Exchange difference	Inventory
A	$9677 gain	$290 323
B	$9677 gain	$300 000
C	$10 345 loss	$300 000
D	$10 345 loss	$310 345

4 Parent Co. has three overseas subsidiaries:

1 A Co. is 80 per cent owned. A Co. does not normally enter into transactions with Parent Co., other than to pay dividends. It operates as a fairly autonomous entity on a day to day basis although Parent Co. controls its long-term strategy.

2 B Co. is 100 per cent owned and has been set up in order to assemble machines from materials provided by Parent Co. These are then transferred to Parent Co., which sells them to third parties.

3 C Co. is 75 per cent owned and is located in France. It manufactures and sells its own range of products locally. It negotiates its own day to day financing needs with French banks.

Which of the subsidiaries are likely to have a different functional currency from Parent Co.?

A A Co. and B Co.
B A Co. and C Co.
C B Co. and C Co.
D all three subsidiaries

5 Archway Co. has an overseas subsidiary in Sweden. This subsidiary is 75 per cent owned and operates semi-independently of its parent. The exchange gain arising from the translation of the subsidiary's financial statements for the year ended 30 June 20X4 was $20 000.

On 1 June 20X4 Archway Co. purchased raw materials from a European supplier for €250 000. It paid for the materials on 31 July 20X4. Relevant exchange rates were:

	€=$1
1 June 20X4	1.6
30 June 20X4	1.61
31 July 20X4	1.63

In respect of these items, what is the exchange gain that should be included in the consolidated statement of profit or loss for the year ended 30 June 20X4?

A $970
B $2876
C $20 970
D $22 876

6 When a parent has a subsidiary that is a foreign operation, which rates of exchange should be used to translate the items below into the parent's local currency?

	Non-current assets	Receivables	Non-current liabilities
A	closing rate	closing rate	closing rate
B	historic rate	closing rate	closing rate
C	historic rate	historic rate	closing rate
D	historic rate	historic rate	historic rate

7 Bay Co. has a foreign subsidiary Sea Co., acquired on 1 January 20X7, which uses the Yoyo as its functional currency. Details of Sea Co. are given below:

Net assets of Sea Co. at 1 Jan 20X7	Yoyo 340 000
Net assets of Sea Co. at 1 Jan 20X8	Yoyo 410 000
Net assets of Sea Co. at 31 Dec 20X8	Yoyo 500 000

Sea Co. has paid no dividends since acquisition. It translates all income and expense items using the average rate for the period.

Relevant exchange rates are:

1 January 20X7	2.1 Yoyo: $1
1 January 20X8	2.0 Yoyo: $1
31 December 20X8	1.8 Yoyo: $1
Average rate 1 Jan X7 – 31 Dec X8	1.95 Yoyo: $1
Average rate 1 Jan X8 – 31 Dec X8	1.9 Yoyo: $1

What exchange difference is included in Bay Co.'s consolidated reserves for the year ended 31 December 20X8?

A $25 410 loss
B $25 410 gain
C $36 386 loss
D $36 386 gain

8 Rain Org is a subsidiary of the Weather Group. Its functional currency is the Zyco, and the presentation currency of the group is the $. The abbreviated statement of financial position of Rain Org at 31 December 20X9 is as follows:

	Zyco
Non-current assets	420 000
Current assets	210 000
Total assets	630 000
Share capital	100 000
Reserves	350 000
Current liabilities	180 000
Equity and liabilities	630 000

Relevant exchange rates are as follows:

3 Zyco: $1 on 31 December 20X9

2.1 Zyco: $1 on date of acquisition of non-current assets

2 Zyco: $1 on date Rain Org acquired by Weather Group

What are the translated reserves of Rain Org at 31 December 20X9?

A $100 000
B $116 667
C $160 000
D $175 000

9 Aardvark Co. bought goods from Hippo Co. for Milanian Pounds (MP) 230 000 on 31 October 20X8. At that date the exchange rate was MP 2.3: $1. Aardvark paid MP 130 000 of the balance on 30 November in accordance with Hippo's terms. On that date the exchange rate was MP 2.1: $1. Aardvark's year end is 31 December 20X8 and on that date the exchange rate was MP 1.8: $1. The balance was settled by Aardvark at the end of January 20X9 when the exchange rate was MP 2: $1.

What exchange difference is recorded in Aardvark's profit or loss for the year ended 31 December 20X8?

A $5383 loss
B $12 078 gain
C $17 461 loss
D $17 461 gain

10 Which of the following is correct?

A Monetary items include all types of current assets.
B Non-monetary items denominated in a foreign currency are never retranslated in an entity's statement of financial position.
C Unrealised exchange differences on the retranslation of monetary items in an entity's individual accounts are recognised in profit or loss.
D An exchange difference arising on the retranslation of a foreign currency loan is recognised in other comprehensive income in an individual entity's financial statements.

17 IFRS 16 *LEASES*

Section overview

- IFRS 16 sets out the accounting treatment of leases and requires the lessee to recognise an asset and liability for most leases.

17.1 THE AIM OF IFRS 16 *LEASES*

A lease is a contract that allows the lessee the right to use an asset for a period of time. The aim of IFRS 16 is to create a single accounting treatment for lessee accounting and this standard replaces IAS 17 on leases. IAS 17 required lessees to classify leases as either a finance lease or an operating lease. This meant that the liability for operating leases was not included on the statement of financial position.

IFRS 16 remedies this by ensuring all leases are included on the lessee's statement of financial position as an asset and with a corresponding liability even though the business does not actually own the asset.

17.2 EXEMPTIONS

The standard allows the lessee to elect to not apply IFRS 16 in the following situations:

- short-term leases – this is a lease for a period of time that is for less than 12 months
- low value leases – when the underlying asset has a low value when new

17.3 INITIAL MEASUREMENT OF THE LEASE

At the inception of the lease the lessee will record an asset and a liability:

Dr. Right to use asset

Cr. Lease liability

The amount will be measured at cost to include:

- the present value of the future lease payments including any expected cash flows at the end of the lease, discounted at the interest rate implicit in the lease
- any lease payments made before the lease commences
- any initial direct costs incurred by the lessee.

17.4 SUBSEQUENT MEASUREMENT OF THE ASSET AND LIABILITY

The right to use asset shall be recognised at the cost model under IAS 16 and should be depreciated over the lower of:

- useful life of the asset; or
- lease term.

This rule is overridden when the lease transfers ownership to the lessee at the end of the lease in which case the right of use asset should be depreciated over the useful life of the asset.

The lease liability is increased by any interest charges and reduced by any payment made under the lease.

Worked Example: Accounting for a lease by the lessee – payments in arrears

A business leases an item of machinery on 1 January 20X4 and pays an initial deposit of $1725 followed by seven instalments of $6000 at the end of each year. The interest rate implicit in the lease is 11 per cent and the present value of the lease instalment payments is $30 000.

Calculate the figures that will be shown in the financial statements for the year ended 31 December 20X4 in respect of the lease.

Solution

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X4

	$
Depreciation expense	4532
Finance cost	3300

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$
Non-current asset	
Right of use asset (31 725 – 4532)	27 193
Non-current liability	
Lease liability	24 303
Current liability	
Lease liability (27 300 – 24 303)	2 997

Workings

The right of use asset will initially be recorded as follows:

Dr.	Right of use asset	$31 725	
Cr.	Lease liability		$30 000
Cr.	Cash		$1 725

The present value of the future cash flows ignores the deposit as this is paid as the lease is taken out.

Lease liability calculation

Date	Narrative	$
1.1.20X4	Initial recording	30 000
31.12.20X4	Interest (30 000 × 11%)	3 300
31.12.20X4	Instalment	(6 000)
		27 300
31.12.20X4	Interest (27 300 × 11%)	3 003
31.12.20X4	Instalment	(6 000)
		24 303

Depreciation

31 725 / 7 years = 4532

Question 17: Accounting for a lease by the lessee – payments in advance

A business leases an item of equipment on 1 January 20X7 and pays an initial deposit of $6000 followed by four instalments of $6000 at the beginning of each year. The interest rate implicit in the lease is 12 per cent and the present value of the future lease payments is $18 225. The useful life of the asset is eight years.

Required

Calculate the figures that will be shown in the financial statements for the year ended 31 December 20X7 in respect of the lease.

(The answer is at the end of the module.)

17.5 ACCOUNTING FOR SHORT-TERM OR LOW VALUE LEASE

The accounting requirements when an entity elects for this option are to recognise a rental expense in profit or loss on a straight line basis or other systematic basis.

Worked Example: Low value lease

On 1 January 20X6 AH Company (AH Co.) entered into a three year lease and paid $400 upfront and three annual payments of $600. AH Co. elected to treat the lease as a low value lease.

What is the expense that AH Co. will recognise in profit or loss for the year ended 31 December 20X6?

Solution

The expense will be $733.

AH Co. is paying a total amount of $2200 (600 × 3 years plus the 400) and that should be spread over the three years to give an annual expense of $733. AH Co. will have a prepayment on their statement of financial position of $267, this being the cash paid of $1000 less the expense of $733.

KEY MODULE POINTS 4

- IFRS 16 *Leases* requires lessees to recognise an asset and a liability for all leases that are for a period of more than 12 months.
- An exception to this is for assets that are of a low value when the initial lease is taken out.
- This means that assets will be recognised as non-current assets by lessees even though the business does not own the asset, this reflects the concept of substance over form. They are known as a right of use asset.
- The right of use asset is initially measured at the present value of the future cash flows of the lease.
- The right of use asset is depreciated over the lower of the lease term and the useful life of the asset.
- A finance cost will be shown in profit or loss based on the interest rate implicit in the lease.
- The lease liability will be calculated by adding on the finance cost and deducting any lease payments.

QUICK REVISION QUESTIONS 4

1. Murray leased a car on 1 January 20X4 with two payments due on 31 December 20X4 and 31 December 20X5 of $14 160 each. The present value of the lease payments is $24 000 and the interest rate implicit in the lease is 12 per cent.
   What is the lease liability that will be shown as a current liability as at 31 December 20X4?
   A $11 021
   B $12 000
   C $12 720
   D $14 160
2. Which of the following situations would require a right-of-use asset to be recognised under IFRS 16?
   I. a lease for a term of 10 years
   II. a lease for a term of six months
   III. a lease for an asset that has a low value when new
   A I only
   B II only
   C II and III only
   D All of the situations
3. Mutley leased an item of equipment on 1 January 20X4 under a lease for a term of five years with an initial deposit of $200 000 and five annual rentals of $600 000 due at the end of the year. The present value of the future cash flows is $2 500 000 and the interest rate implicit in the lease is 10 per cent.
   What is the finance charge that will be recognised in profit or loss for the year ended 31 December 20X4?
   A $190 000
   B $250 000
   C $270 000
   D $300 000
4. Using the information from question 3:
   What is the lease liability that will be shown as a current liability as at 31 December 20X4?
   A $215 000
   B $385 000
   C $451 000
   D $600 000
5. Sammy enters into a five year lease for an asset with a useful life of six years. Sammy pays an initial deposit of $10 000 and the present value of the future cash flows is $65 000. The ownership of the asset will transfer over to Sammy at the end of the lease.
   What is the carrying value of the asset at the end of the first year?
   A $52 000
   B $54 167
   C $60 000
   D $62 500

ANSWERS TO QUICK REVISION QUESTIONS 1

1 A Deferred development expenditure b/f is $480 000 (cost $500 000 – accumulated amortisation $20 000), then deduct annual amortisation of $10 000 to give figure c/f of $470 000.

2 C I Development expenditure must be capitalised if the criteria are met.
II There is no time scale given by IAS 38 for amortisation.

3 D A and B are still in the research phase; C is in the development phase however problems mean that it is still sufficiently distant from commercial production to write off expenses as incurred.

4 A Amortisation commences when production commences and therefore the amortisation charge relates to an eight-month period. Amortisation should reflect the pattern of benefits; in this case the first year's benefit is half that of later years, therefore:
0.5/9.5 × $210 000 × 8/12m = $7368
* There are 10 years of amortisation, although the first year attracts only half the charge of the subsequent nine years. Therefore the denominator is 9.5, being (1 year × ½) + (9 years × 1)

5 C Amortisation does not start until commercial production commences.

6 B Intangible assets meeting the capitalisation criteria of IAS 38 **must** be capitalised and depreciated where they have a finite life. Any intangible assets which are deemed to have an indefinite life are instead tested annually for impairment. Any amortisation is charged to profit or loss.

7 C The asset must be identifiable. An asset which is capable of separate disposal is identifiable however separability is not an essential feature of an intangible asset. For example, production rights may not be capable of separate sale without a particular machine, however they still qualify as an intangible asset.

8 C Only intangible assets which have an indefinite useful life or are not yet available for use must be reviewed for impairment annually. All others undergo an impairment review if there are indications of an impairment.

9 B $900 000/25 × 5/12 months = $15 000 amortisation to the end of the year.
Therefore carrying amount is $900 000 – $15 000 = $885 000.
Marketing costs must be expensed as incurred.

10 A Patents are purchased intangible assets and as such should be capitalised. The costs of staff training and advertising, even where these are expected to result in future economic benefits, cannot be capitalised according to IAS 38.

11 B A revaluation surplus is recognised as other comprehensive income in the period in which it arises. An impairment loss suffered on a previously revalued asset may be recognised as other comprehensive income to the extent that a revaluation surplus exists in respect of that asset. An impairment loss suffered on an asset held at depreciated cost must be recognised in profit or loss.

12 D The impairment would have been written off to profit or loss as there is no credit in the revaluation surplus for this asset. So only the increase in head office value appears in the revaluation surplus.

13 C Most non-current assets only require testing for impairment if there are indicators of impairment, rather than annually.

14 A The impairment loss is applied first against the goodwill and then against the other non-current assets on a pro-rata basis. It will be allocated as follows:

	$m
Building	10
Plant and equipment	5
Goodwill	5
	20

The carrying amount of the building will then become $10m (20 – 10).

15 C Goodwill acquired in a business combination should be reviewed for impairment annually.

16 B

	Property $	Revaluation reserve $
Cost 1 April 20X5	700 000	
Depreciation (700 000 × 2 / 50)	(28 000)	
CV at 1 April 20X7	672 000	
Revaluation surplus	288 000	288 000
	960 000	
Depreciation y/e 31 March 20X8 (960 000 / 48)	(20 000)	
Excess depreciation (20 – 14)		(6 000)
CV at 31 March 20X8	940 000	282 000
Impairment loss	(340 000)	(282 000)
Impaired value	600 000	

17 C

	$	Revaluation reserve $
Cost	300 000	
Revaluation	50 000	50 000
X3	350 000	
Revaluation	50 000	50 000
X4	400 000	100 000
Impairment	(115 000)	(100 000)
FV less costs of disposal	285 000	–

The balance of the impairment loss ($15 000) is charged to profit or loss.

18 A A reversal of an impairment loss in relation to goodwill cannot be recognised.

19 C The carrying amount of the machine on the date of the impairment test is $68 000 ($80 000 × 8.5 / 10). The recoverable amount is $66 000 (the higher of the value in use and the fair value less costs of disposal). Therefore the asset is impaired and its carrying amount is reduced to $66 000. The depreciation charge for the following year is therefore $66 000 / 8.5 years.

20 D A head office building which is shared by a number of CGUs (a corporate asset) is only tested for impairment on an individual basis if it cannot be allocated to CGUs on a reasonable and consistent basis. An intangible asset with an indefinite useful life is tested for impairment annually; however the test may take place at any time during the reporting period providing that it is the same time each year.

ANSWERS TO QUICK REVISION QUESTIONS 2

1 B No sale has taken place, so DT must show that it is holding $90 000 which belongs to XX.

2 C The revenue on the system can be recognised immediately of $3560 (4000 × 89%) and the revenue on the servicing of $440 (4000 x 11%) should be spread over the year.

	$	%
System	4000	89
Servicing	500	11

3 B Settlement discounts count as variable consideration and any expected discounts should be deducted from revenue.
Tuition fees are revenue from the provision of a service and should be recognised over the period that the tuition is provided.

4 C

	$
Tax charge (30% × $582 000)	174 600
Over-provision from X7 ($502 000 × 30%) – 149 000	(1 600)
	173 000

5 C The deferred tax liability will be the tax on temporary differences at the year end, i.e. ((2 650 000 – 1 872 000) × 20%) = $155 600. Answer A is the deferred tax part of the year's tax charge (the amount by which the liability is increased) i.e. $155 600 – $128 500. Answer B is the opening balance rather than the year end balance. Answer D is the difference between the carrying amount and the tax WDV, i.e. the temporary difference itself rather than the tax on the difference.

6 D The creation of a deferred tax liability will increase the tax charge, so reducing profit after tax for the year that is, the entry will be *Dr.* tax charge, *Cr.* deferred tax liability.

7 A A carrying amount of $3 570 000 less tax WDV of $2 450 000 = $1 120 000 and at 22 per cent a liability of $246 400 is required. There is already a liability of $250 000 so a credit of $3600 will be reported.

8 A

		$
Current tax		53 960
Deferred tax (see below)		(5 600)
		48 360
Deferred tax – liability required	=	$80 000 × 24%
	=	19 200
Opening balance on deferred tax	=	24 800
Decrease		5 600

9 B Deferred tax is recorded as a non-current liability; it does not represent an amount currently payable, but is an accounting adjustment made in order to 'smooth' the tax charge so that the tax charged in a period is in line with the profits made in that period.

10 A A deferred tax asset arises in respect of the losses carried forward which are expected to be utilised against future profits that is, $185 000 ($320 000 – $120 000 – $15 000). The asset is calculated by applying the tax rate of 25 per cent.

11 C A deferred tax liability is the result of a taxable temporary difference. Deferred tax arising on a revaluation is recognised in other comprehensive income.

12 A Deferred tax on the accelerated capital allowances (recognised in profit or loss)

	$
Carrying amount (580 000 – 80 000)	500 000
Tax base (580 000 – 130 000)	450 000
Temp difference	50 000
Deferred tax liability c/f (20% × $50 000)	10 000
Deferred tax liability b/f	9 000
Increase in liability/charge to profits	1 000
Deferred tax on revaluation (recognised as OCI) $100 000 × 20%	20 000

13 A

	$
Tax charge for current year = liability	56 000
Decrease in deferred tax liability	(6 000)
Over-provision (balancing figure)	(2 500)
Tax charge to profits	47 500

ANSWERS TO QUICK REVISION QUESTIONS 3

1 C The functional currency of an entity is the currency in which its day to day transactions are denominated; the presentation currency is chosen by the management and is the currency in which the financial statements are prepared.

2 A 600 000 crowns / 7 = $85 714
The closing rate must be used.

3 C

	$
1 November 20X6 (450 000 × 1.5)	300 000
31 December 20X6 (450 000 × 1.45)	(310 345)
	(10 345)

The inventory is a non-monetary asset. It is translated at the date of the original transaction and remains in the statement of financial position at that amount.

4 B Subsidiary B Co. is clearly an extension of Parent's Co.'s own activities and therefore it almost certainly has the same functional currency as the parent.

5 A Exchange gain:

	$
Purchase from European supplier:	
1 June 20X4 (250 000 × 1.6)	156 250
30 June 20X4 (250 000 × 1.61)	(155 280)
	970

The overseas subsidiary has a different functional currency from its parent (i.e. it is a semi-autonomous operation) and therefore the translation gain of $20 000 is recognised in consolidated reserves rather than reported in profit or loss.

6 A The assets and liabilities of a foreign subsidiary are always translated at closing rate, not historic rate, where the subsidiary has a different functional currency from its parent.

7 B

	$	$
Opening net assets at opening rate (410 000 / 2)	205 000	
Opening net assets at closing rate (410 000 / 1.8)	227 778	
Gain		22 778
Profit for year at average rate (500 000 – 410 000) / 1.9	47 368	
Profit for year at closing rate (90 000 / 1.8)	50 000	
Gain		2 632
Overall exchange gain		25 410

8 A

	$
Total assets (630 000 / 3)	210 000
Share capital (100 000 / 2)	50 000
Reserves (bal)	100 000
Current liabilities (180 000 / 3)	60 000
Equity and liabilities	210 000

9 C Exchange difference on settled amount:

	$
MP 130 000 / 2.3	56 522
MP 130 000 / 2.1	61 905
Loss	5 383

Exchange difference on retranslation of outstanding amount at year end:

	$
MP 100 000 / 2.3	43 478
MP 100 000 / 1.8	55 556
Loss	12 078
Overall loss	17 461

10 D Unrealised exchange differences on the retranslation of monetary items in individual entity financial statements are recognised in profit or loss, not other comprehensive income.
Monetary items do not include current assets such as inventories and prepayments, which are classified as non-monetary items.
Non-monetary items denominated in a foreign currency have to be retranslated before they can be included in the statement of financial position.

ANSWERS TO QUICK REVISION QUESTIONS 4

1 C

Dates	Narrative	$
1.1.20X4	Initial recognition	24 000
31.12.20X4	Interest (24 000 × 12%)	2 880
31.12.20X4	Instalment	(14 160)
	Liability	12 720

2 A For leases that are less than 12 months or that have a low value at inception the business can elect to use the simplified accounting under IFRS 16.

3 B $2 500 000 × 10% = $250 000

4 B 2 150 000 – 1 765 000 = $385 000

Dates	Narrative	$
1.1.20X4	Initial recognition	2 500 000
31.12.20X4	Interest	250 000
31.12.20X4	Instalment	(600 000)
	Liability	2 150 000
	Interest (2 150 000 × 10%)	215 000
	Instalment	(600 000)
31.12.20X5	Liability	1 765 000

5 D The right of use asset is initially recognised at $75 000 (10 000 + 65 000) and this is depreciated over six years to give a depreciation charge of $12 500 ($75 000 / 6), giving a carrying value of $62 500 ($75 000 – $12 500). The asset is depreciated over six years rather than five years as the lessee takes ownership at the end of the lease term.

ANSWERS TO MODULE QUESTIONS

1 **Project A**

This project meets the criteria in IAS 38 for development expenditure to be recognised as an asset. The project is technically feasible and the company intends to complete it so that the resulting product will be available for sale. There is a market for the product and its sale will result in future economic benefits. In the absence of other information it is assumed that the company has adequate technical, financial and other resources to complete the development and to use or sell the intangible asset. The company is clearly able to measure reliably the expenditure attributable to the intangible asset during its development, because it has been able to estimate total costs and expected revenue.

Hence the costs of $280 000 incurred to date should be transferred from research and development costs to capitalised development expenditure and carried forward until revenues are generated; they should then be matched with those revenues.

Project B

While this project meets most of the criteria discussed above which would enable the costs to be carried forward it fails on the requirements that 'adequate resources exist, or their availability can be demonstrated, to complete the project'.

Therefore, these costs should be written off as an expense in profit or loss. Once funding is obtained the situation can then be reassessed and future costs may be capitalised.

Project C

This is a research project according to IAS 38, i.e. original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge or understanding.

There is no certainty as to its ultimate success or commercial viability and therefore it cannot be considered to be a development project. IAS 38 therefore requires that costs be written off as incurred.

2 (a) STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	$
Research expenditure (Project C + 1 420 000)	1 530 000
Development costs (Project B)	150 000
Amortisation of capitalised development costs	240 000

(b) STATEMENT OF FINANCIAL POSITION (EXTRACT)

	$
Non-current assets	
Intangible assets	
Deferred development costs	1 280 000

(c) NOTE TO FINANCIAL STATEMENTS

Deferred development costs

	$
Cost	
Balance b/f	1 480 000
Additions during year (Project A)	280 000
Balance c/f	1 760 000
Amortisation	
Balance b/f	240 000
Charge during year	240 000
Balance c/f	480 000
Net carrying amount at 30 September 20X5	1 280 000
Net carrying amount at 30 September 20X4	1 240 000

3 Here are two possibilities:

(a) A mining company owns a private railway that it uses to transport output from one of its mines. The railway now has no market value other than as scrap, and it is impossible to identify any separate cash inflows with the use of the railway itself. Consequently, if the mining company suspects an impairment in the value of the railway, it should treat the mine as a whole as a cash generating unit, and measure the recoverable amount of the mine as a whole.

(b) A bus company has an arrangement with a town's authorities to run a bus service on four routes in the town. Separately identifiable assets are allocated to each of the bus routes, and cash inflows and outflows can be attributed to each individual route. Three routes are running at a profit and one is running at a loss. The bus company suspects that there is an impairment of assets on the loss-making route. However, the company will be unable to close the loss-making route, because it is under an obligation to operate all four routes, as part of its contract with the local authority. Consequently, the company should treat all four bus routes together as a cash generating unit, and calculate the recoverable amount for the unit as a whole.

4 In identifying Minimart's cash-generating unit, an entity considers whether, for example:

- Internal management reporting is organised to measure performance on a store-by-store basis.
- The business is run on a store-by-store profit basis or on a region or city basis.

All Maximart's stores are in different neighbourhoods and probably have different customer bases. So, although Minimart is managed at a corporate level, Minimart generates cash inflows that are largely independent from those of Maximart's other stores. Therefore, it is likely that Minimart is a cash-generating unit.

5 The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible non-current assets to what it would have been had the impairment not taken place, i.e. a reversal of the impairment loss of $10m is recognised and the tangible non-current assets written back to $70m. Reversal of the impairment is not recognised in relation to the goodwill and patent because the effect of the external event that caused the original impairment has not reversed – the original product is still overtaken by a more advanced model.

6 A.

Dr.	Trade receivables control account	$5400		
Cr.	Sales		$5400	

As Freddie expects the customer to take up the settlement discount the sale is recorded at 90% of the $6 000.

B.

Dr.	Cash	$6000		
Cr.	Trade receivables control account		$5400	
Cr.	Sales		$600	

As the customer pays on 16 May 20X7 they will not be entitled to the settlement discount so Freddie will receive an additional $600 of sales revenue.

7 The cleaning company should recognise the revenue as they satisfy the performance obligations, this will mean they should recognise them over a period of time. The contract requires them to clean over a two year period so the total amount should be spread over the two years. For the year ended 31 December 20X1 they will recognise revenue of $7500 ($15 000 / 2 years) and they will have deferred income (shown under current liabilities) of $2500 ($10 000 – $7500).

8 The airline satisfies the performance obligation in January when they provide the flight to the customer so revenue should be recognised in January.

9 (a)

	$
Estimated tax charge for the 20X8 year ($120 000 × 30%)	36 000
Under provision relating to the previous year	5 000
Tax expense	41 000

(b)

	$
Estimated tax charge for the 20X8 year ($120 000 × 30%)	36 000
Over provision relating to the previous year	(5 000)
Tax expense	31 000

10 (a) The tax base of the machine is $7000. As $3000 has already been deducted, $7000 will be deducted in the future.
(b) The tax base of the interest receivable is nil. It will be fully taxable in the future, so that zero is deductible in the future.
(c) The tax base of the trade receivables is $10 000. Since it has already been taxed in full, it is not taxable in the future (and so it is deductible).
(d) The tax base of the loan is $1m. Since economic benefits are not taxable, the tax base is the same as the carrying amount.

11 (a) The tax base of the accrued expenses is nil. Since whole amount will be deducted in the future, tax base is $1000 – $1000 = $0.
(b) The tax base of the interest received in advance is nil. This is carrying amount of $10 000 less $10 000 (the amount is not taxable in the future, since it's already taxed).
(c) The tax base of the accrued expenses is $2000. This is the carrying amount of $2000 less $0. Since it was already deducted for tax purposes, it will not be deducted in the future.
(d) The tax base of the accrued fines and penalties is $100. Since it cannot be deducted in the future, this is $100 – $0 = $100.
(e) The tax base of the loan is $1m. Since no tax consequences, the tax base is equal to the carrying value.

12 Jonquil Co. will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the entity's current tax computation is as follows:

	Year				
	20X1	20X2	20X3	20X4	20X5
	$	$	$	$	$
Taxable income*	10 000	10 000	10 000	10 000	10 000
Depreciation for tax purposes	12 500	12 500	12 500	12 500	0
Taxable profit (tax loss)	(2 500)	(2 500)	(2 500)	(2 500)	10 000
Current tax expense (income) at 40%	(1 000)	(1 000)	(1 000)	(1 000)	4 000

* That is, nil profit plus $50 000 / 5 depreciation add-back.

The entity recognises a current tax asset at the end of years 20X1 to 20X4 because it recovers the benefit of the tax loss against the taxable profit of year 20X5.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows:

	Year				
	20X1	20X2	20X3	20X4	20X5
	$	$	$	$	$
Carrying amount	40 000	30 000	20 000	10 000	0
Tax base	37 500	25 000	12 500	0	0
Taxable temporary difference	2 500	5 000	7 500	10 000	0
Opening deferred tax liability	0	1 000	2 000	3 000	4 000
Deferred tax exp (income): bal fig.	1 000	1 000	1 000	1 000	(4 000)
Closing deferred tax liability × 40%	1 000	2 000	3 000	4 000	0

The entity recognises the deferred tax liability in years 20X1 to 20X4 because the reversal of the taxable temporary difference will create taxable income in subsequent years.

The entity's statement of profit or loss is as follows:

	Year				
	20X1	20X2	20X3	20X4	20X5
	$	$	$	$	$
Income	10 000	10 000	10 000	10 000	10 000
Depreciation	(10 000)	(10 000)	(10 000)	(10 000)	(10 000)
Profit before tax	0	0	0	0	0
Current tax expense (income)	(1 000)	(1 000)	(1 000)	(1 000)	4 000
Deferred tax expense (income)	1 000	1 000	1 000	1 000	(4 000)
Total tax expense (income)	0	0	0	0	0
Profit before tax for the period	0	0	0	0	0

13

(a)

	$
Income tax on profits (liability in the statement of FP)	45 000
Deferred taxation	16 000
Under-provision of tax in previous year $(40 500 – 38 000)	2 500
Tax on profits for 20X3 (profit or loss)	63 500

(b) Tax payable on 20X3 profits (liability) 45 000

14 (a) **Tax expense for the year**

		$
(i)	Tax on trading profits (30% of $1 200 000)	360 000
	Tax on capital gain	18 000
	Deferred taxation	20 000
		398 000
	Under-provision of taxation in previous years $(84 000 – 80 000)	4 000
	Tax expense on profit for the period	402 000

(ii) **Note:** The statement of profit or loss and other comprehensive income will show the following:

	$
Profit before tax (1 200 000 + 60 000)	1 260 000
Income tax expense	(402 000)
Profit for the year	858 000

(b)

Deferred taxation

Balance brought forward	100 000
Transferred from profit or loss	20 000
Deferred taxation in the statement of financial position	120 000

The tax liability is as follows:

Payable on 1 May 20X5	$
Tax on profits (30% of $1 200 000)	360 000
Tax on capital gain (30% of $60 000)	18 000
Due on 1 May 20X5	378 000

Summary

Current liabilities

Tax payable on 1 May 20X5	378 000

Non-current liabilities

Deferred taxation	120 000

Note: It may be helpful to show the journal entries for these items.

		$	$
Dr.	Tax expense (profit or loss)	402 000	
Cr.	Tax payable		*382 000
	Deferred tax		20 000

* This account will show a debit balance of $4000 until the under-provision is recorded, since payment has already been made: (360 000 + 18 000 + 4000).
The closing balance will therefore be $378 000.

15 The purchase will be recorded in the books of White Cliffs Co. using the rate of exchange ruling on 30 September.

Dr.	Purchases	$25 000	
Cr.	Trade payables		$25 000

Being the $ cost of goods purchased for €40 000 (€40 000 / €1.60/$1)

On 30 November, White Cliffs must pay €20 000. This will cost €20 000 / €1.80/$1 = $11 111 and the company has therefore made an exchange gain of $12 500 – $11 111 = $1389.

Dr.	Trade payables	$12 500	
Cr.	Exchange gains: (profit or loss)		$1 389
Cr.	Cash		$11 111

On 31 December, the year end, the outstanding liability will be recalculated using the rate applicable to that date: €20 000 / €1.90/$1 = $10 526. A further exchange gain of $1974 has been made and will be recorded as follows:

Dr.	Trade payables	$1 974	
Cr.	Exchange gains: (profit or loss)		$1 974

The total exchange gain of $3363 will be included in the operating profit for the year ending 31 December.

On 31 January, White Cliffs must pay the second instalment of €20 000. This will cost it $10 811 (€20 000 / €1.85/$1).

Dr.	Trade payables	$10 526	
	Exchange losses: (profit or loss)	$285	
Cr.	Cash		$10 811

16 SUMMARISED STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X9

	$	$
Non-current assets (carrying amount) ($1: €1)		300
Current assets		
Inventories ($1: €1)	200	
Receivables ($1: €1)	100	
		300
		600
Equity and liabilities		
Equity		
Ordinary shares (€100/1.8)	55	
Pre-acquisition reserves (€120/1.8)	67	
Post-acquisition reserves (balancing figure)	258	
		380
Non-current liabilities ($1: €1)		110
Current liabilities ($1: €1)		110
		600

SUMMARISED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X9

	$
Profit before tax (€300/1.6)	187.5
Tax (€140/1.6)	(87.5)
Profit after tax, retained	100

17 STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X7

	$
Depreciation expense	4 845
Finance cost	2 187

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X7

	$
Non-current asset	
Right of use asset (24 225 – 4845)	19 380
Non-current liability	
Lease liability (20 412 – 6000)	14 412
Current liability	
Lease liability	6 000

Workings

The right of use asset will initially be recorded as follows:

Dr.	Right of use asset	$24 225	
Cr.	Lease liability		$18 225
Cr.	Cash		$6 000

The present value of the future cash flows ignores the first payment as this is paid as the lease is taken out.

Lease liability calculation

Date	Narrative	$
1.1.20X7	Initial recording	18 225
31.12.20X7	Interest (18 225 × 12%)	2 187
		20 412

Depreciation

24 225 / 5 years = $4845

MODULE 4

MODULE 5
BUSINESS COMBINATIONS

Learning objectives	Reference
Discuss the accounting issues for various forms of business combinations	LO5.1
Explain how goodwill is measured and disclosed at the date of acquisition and prepare the relevant journal entries	LO5.2
Explain how goodwill is measured and impaired subsequent to acquisition and prepare the relevant journal entries	LO5.3
Discuss the concept of control and calculate the non-controlling interest share of equity	LO5.4
Prepare consolidated statements of financial position, including the entries for goodwill and non-controlling interests	LO5.5
Prepare consolidated statements of profit or loss and other comprehensive income, including the entries for non-controlling interests and intra-group transactions	LO5.6

Topic list

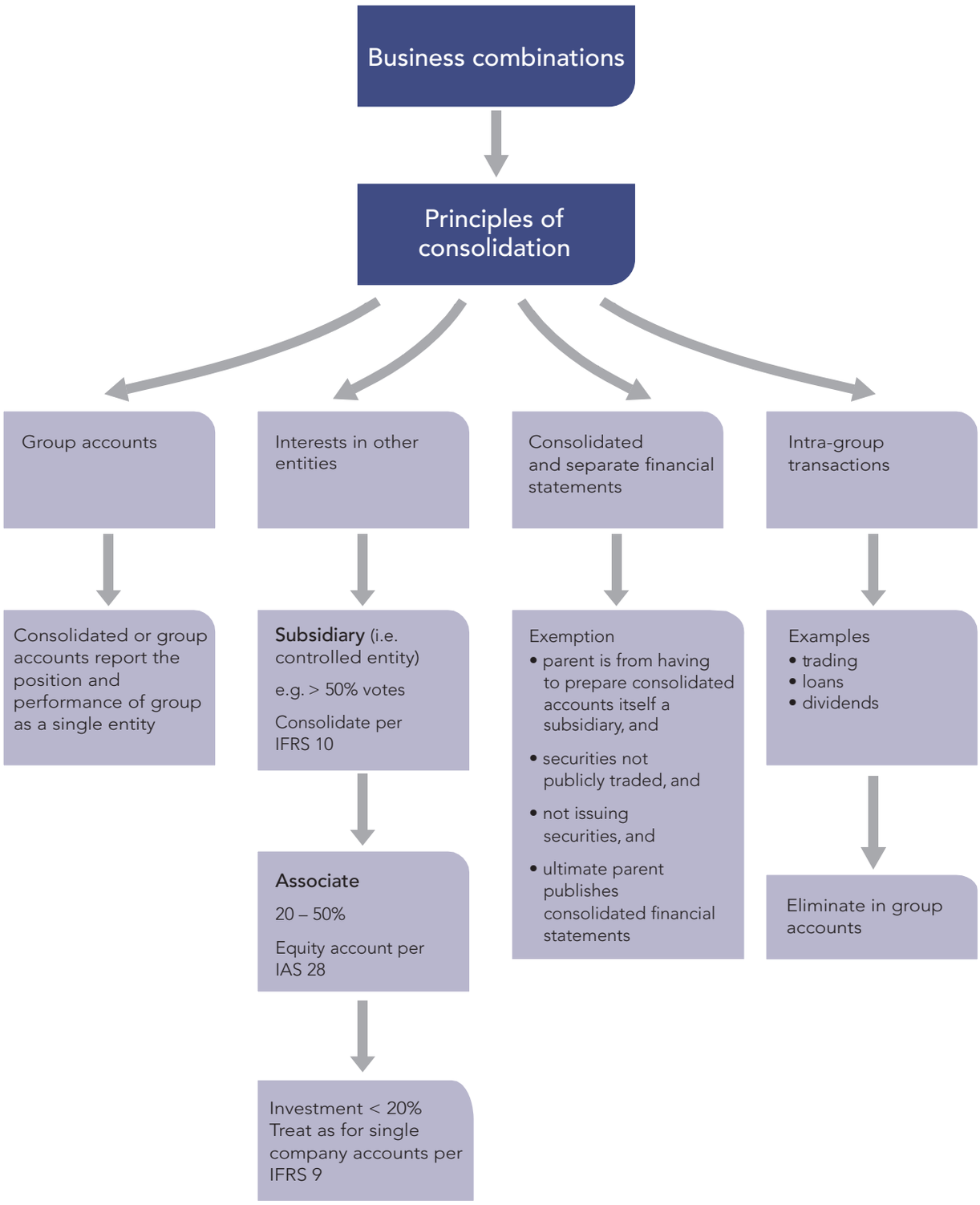
1 Group accounts – a subject outline
2 Group companies
3 Consolidated and separate financial statements
4 Intra-group transactions
5 Non-controlling interests
6 Goodwill arising on consolidation
7 Basic principles of the consolidated statement of financial position
8 Comprehensive example
9 Intra-group trading
10 Intra-group sales of non-current assets
11 Summary: consolidated statement of financial position
12 Acquisition of a subsidiary during its accounting period
13 Fair values in acquisition accounting
14 Basic principles of the consolidated statement of profit or loss
15 Intra-group transactions
16 Pre-acquisition profits and mid-year acquisitions
17 Other adjustments
18 Summary: consolidated statement of profit or loss
19 Accounting for associates
20 The equity method
21 Consolidated statement of profit or loss
22 Consolidated statement of financial position
23 Adjustments

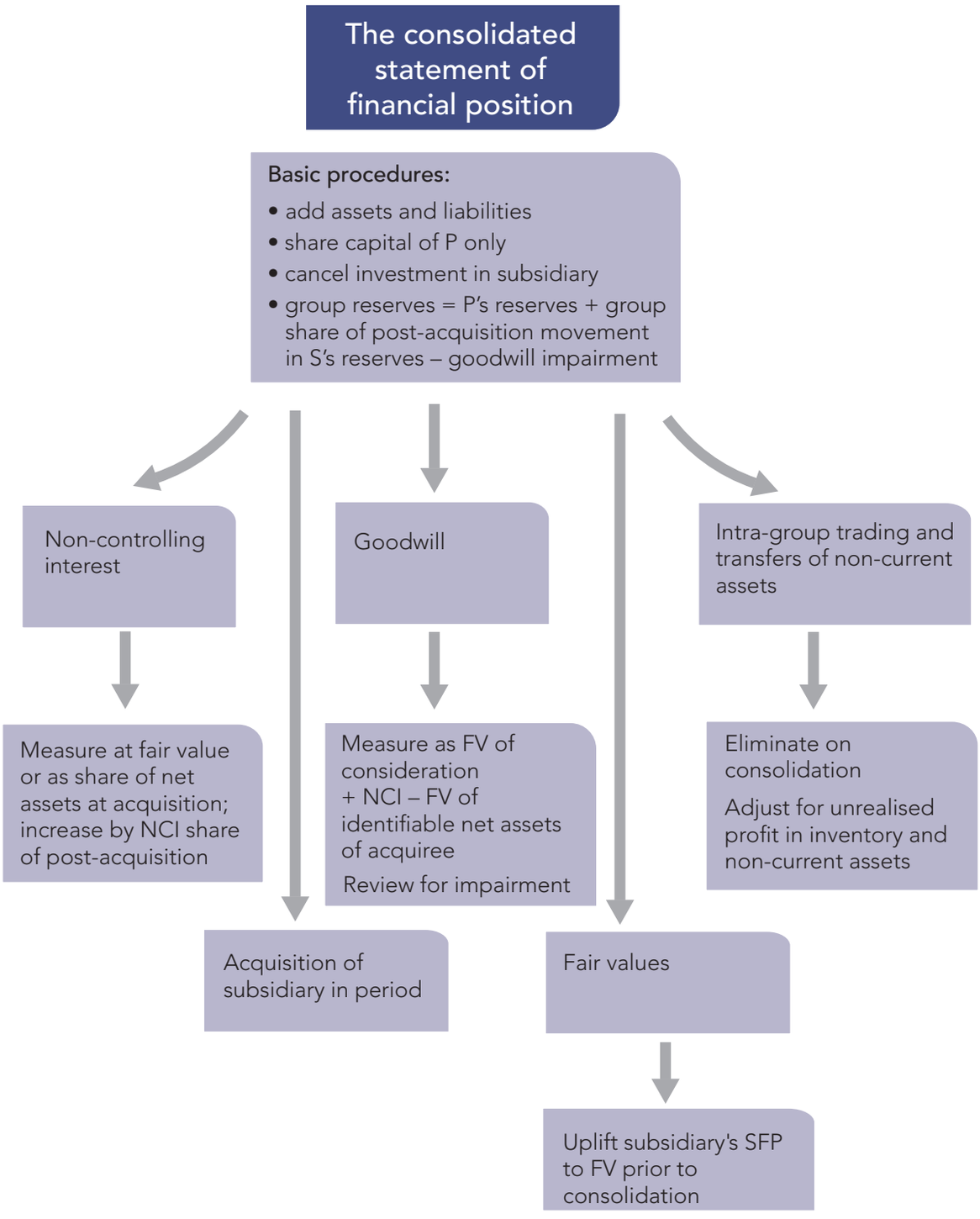
MODULE OUTLINE

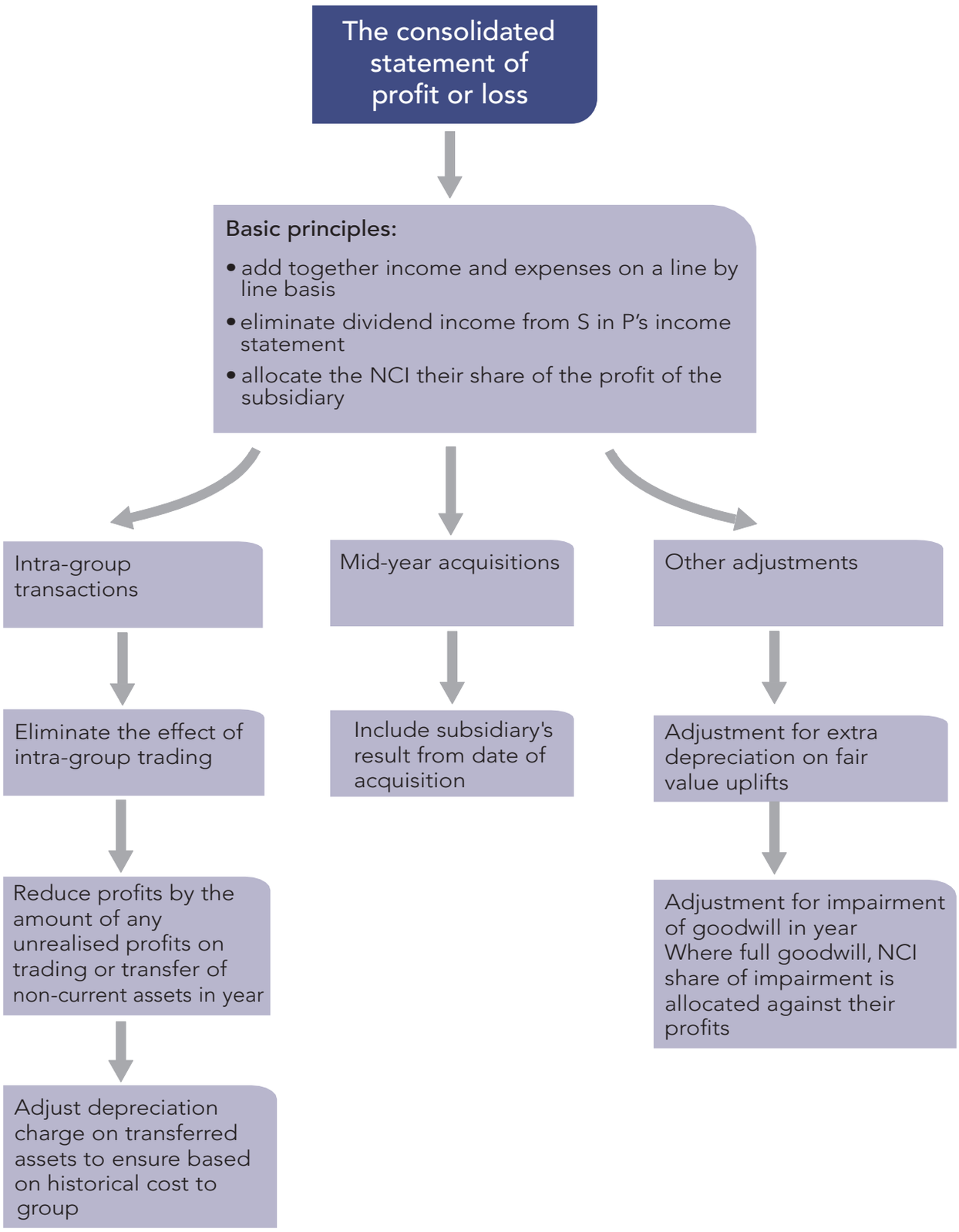
Consolidation is an extremely important area of your studies. In this module we begin by looking at the major definitions used in consolidation. These matters are fundamental to your comprehension of consolidated financial statements, so make sure you understand them and then **learn them**.

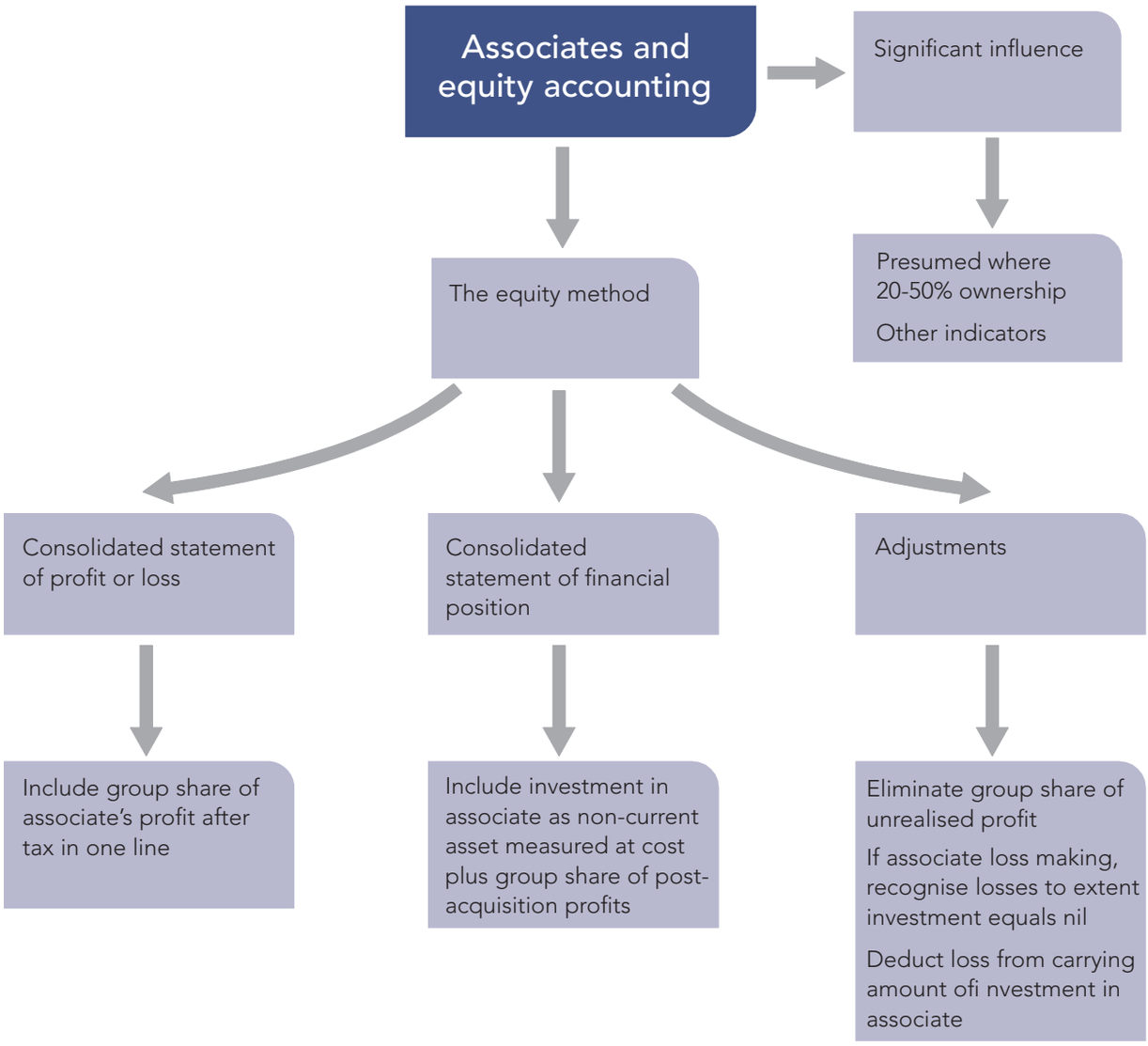
We then move onto the treatment of associates in consolidated financial statements, before ending with a detailed examination of the consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income.

The module content is summarised in the diagrams below.




The consolidated statement of financial position
Basic procedures:
• add assets and liabilities
• share capital of P only
• cancel investment in subsidiary
• group reserves = P's reserves + group share of post-acquisition movement in S's reserves – goodwill impairment
Non-controlling interest
Measure at fair value or as share of net assets at acquisition; increase by NCI share of post-acquisition
Goodwill
Measure as FV of consideration + NCI – FV of identifiable net assets of acquiree
Review for impairment
Intra-group trading and transfers of non-current assets
Eliminate on consolidation
Adjust for unrealised profit in inventory and non-current assets
Acquisition of subsidiary in period
Fair values
Uplift subsidiary's SFP to FV prior to consolidation


The consolidated statement of profit or loss
Basic principles:
• add together income and expenses on a line by line basis
• eliminate dividend income from S in P's income statement
• allocate the NCI their share of the profit of the subsidiary
Intra-group transactions
Eliminate the effect of intra-group trading
Reduce profits by the amount of any unrealised profits on trading or transfer of non-current assets in year
Adjust depreciation charge on transferred assets to ensure based on historical cost to group
Mid-year acquisitions
Include subsidiary's result from date of acquisition
Other adjustments
Adjustment for extra depreciation on fair value uplifts
Adjustment for impairment of goodwill in year
Where full goodwill, NCI share of impairment is allocated against their profits



Business combinations: Module summary diagram

BEFORE YOU BEGIN

If you have studied these topics before, you may wonder whether you need to study this module in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the module to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the module you can find the information, and you will also find a commentary at the back of the Study Guide.

1 What is a subsidiary? (Section 2.1)
2 What is an associate? (Section 2.1)
3 How is control established? (Section 2.2)
4 How is significant influence established? (Section 2.3)
5 How are a subsidiary and an associate accounted for in the group accounts? (Section 2)
6 Which subsidiaries may be excluded from a consolidation? (Section 3.3)
7 What is the non-controlling interest and how is it measured at acquisition? (Section 5.1)
8 What are the basic consolidation procedures regarding assets and liabilities and share capital? (Section 5.2)
9 When does goodwill arise in a consolidated statement of financial position? (Section 6)
10 How is goodwill accounted for? (Section 6.1)
11 How is goodwill calculated? (Sections 6.3 and 6.4)
12 How is a bargain purchase accounted for? (Section 6.8)
13 How is contingent consideration accounted for in calculating goodwill? (Section 6.9.1)
14 What is an unrealised profit in a group context? (Section 9.1)
15 How is an unrealised profit accounted for? (Sections 9.1 and 9.2)
16 What consolidation adjustments are required where the fair value of the subsidiary's net assets differ from book value? (Section 13.3)
17 What are the basic consolidation procedures for income and expenses and dividends received by the parent from subsidiary entities? (Section 14)
18 How is the non-controlling interest in profit calculated? (Section 14)
19 How are sales made by a subsidiary to a parent dealt with in the consolidated statement of profit or loss? (Section 15.1)
20 What adjustment is required for an unrealised profit on inventory? (Section15.1)
21 Where a non-current asset has been transferred between group entities in the accounting period, how is the unrealised profit calculated? (Section 15.2)
22 How is the mid-year acquisition of a subsidiary dealt with in the consolidated statement of profit or loss? (Section 16)
23 Where is an impairment of goodwill usually charged in the consolidated statement of profit or loss? (Section 17.2)
24 What method is applied to account for an associate in the consolidated financial statements? (Section 19.1)
25 How is an associate represented in the consolidated statement of profit or loss? (Section 21)
26 How is an investment in an associate calculated for inclusion in the consolidated statement of financial position? (Section 22)
27 What adjustment is required where an unrealised profit arises on a sale of goods from the associate to the parent company? (Section 23.1)
28 How is any impairment of an investment in an associate accounted for? (Section 23.3)

1 GROUP ACCOUNTS – A SUBJECT OUTLINE

Section overview

- Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a **group**. The controlling company, called the **parent** or **holding company**, will own some or all of the shares in the other companies, referred to as **subsidiaries**.

1.1 SUBJECT OUTLINE

There are many reasons for one company to buy all or part of another: for the goodwill associated with the names of the subsidiaries, for tax or legal purposes and so forth. In many cases, one company will grow by buying other companies.

A **group of companies** consists of a **parent company** and one or more **subsidiary companies** that are controlled by the parent company.

1.2 THE NEED FOR GROUP FINANCIAL STATEMENTS

The information contained in the individual financial statements of a parent company and each of its subsidiaries does not always give a picture of the group's total activities. Users of the accounts will be unable to obtain an understanding of the overall position and performance of the group by looking at the numerous financial statements of the individual companies that make up the group.

Therefore, consolidated financial statements are prepared.

Consolidated financial statements combine the information contained in the separate accounts of a holding company and its subsidiaries as if they were the accounts of a single entity. 'Group accounts' and 'consolidated accounts' are terms used synonymously in practice.

Most parent companies present their own individual accounts and their group accounts in a single **package**. The package typically comprises the:

- **parent company financial statements**, which will include 'investments in subsidiaries' as an asset in the statement of financial position, and income from subsidiaries (dividends) in the statement of profit or loss and other comprehensive income;
- **consolidated statement of financial position;**
- **consolidated statement of profit or loss and other comprehensive income;**
- **consolidated statement of changes in equity; and**
- **consolidated statement of cash flows**.

It may not be necessary to publish all of the parent company's financial statements, depending on local or national regulations.

1.3 ACCOUNTING STANDARDS

We will discuss four accounting Standards in this module:

- IAS 27 *Separate Financial Statements*
- IFRS 3 *Business Combinations*
- IFRS 10 *Consolidated Financial Statements*
- IAS 28 *Investments in Associates and Joint Ventures*

These standards are all concerned with different aspects of group financial statements, but there is some overlap between them.

In the first part of this module we will concentrate on IAS 27 and IFRS 10, which cover the basic group definitions and consolidation procedures of a parent-subsidiary relationship. First, we consider all the important definitions which **determine how to treat each particular type of investment** in group financial statements.

2 GROUP COMPANIES

LO 5.1

Section overview

- A subsidiary is an entity controlled by another entity, its parent. IFRS 10 provides a definition of control.

2.1 DEFINITIONS

Exam comments

All the definitions relating to group accounts are extremely important. You must **learn them** and **understand** their meaning and application.

Definitions

Control. An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee. (IFRS 10)

Power. Existing rights that give the current ability to direct the relevant activities of the investee. (IFRS 10)

Subsidiary. An entity that is controlled by another entity. (IFRS 10)

Parent. An entity that controls one or more subsidiaries. (IFRS 10)

Group. A parent and all its subsidiaries. (IFRS 10)

Associate. An entity over which the investor has significant influence. (IAS 28)

Significant influence is the power to participate in the financial and operating policy decisions of an investee but is not control or joint control over those policies. (IAS 28)

Note that the definitions above refer to 'entities' rather than 'companies'. There is no requirement for members of accounting groups to be companies and groups may include partnerships or other non-corporate entities. Throughout this module we shall, however, concentrate on groups made up solely of companies.

We can summarise the different types of investment *and* the required accounting for them as follows:

INVESTMENT	CRITERIA	REQUIRED TREATMENT IN GROUP ACCOUNTS
Subsidiary	Control	Full consolidation
Associate	Significant influence	Equity accounting
Investment which is neither of the above	No significant influence	As in single company accounts

2.2 INVESTMENTS IN SUBSIDIARIES

The important point here is **control**.

IFRS 10 provides a definition of control and identifies three separate elements of control:

An investor controls an investee if, and only if, it has all of the following:

1. power over the investee;
2. exposure to, or rights to, variable returns from its involvement with the investee; and
3. the ability to use its power over the investee to affect the amount of the investor's returns.

If there are changes to one or more of these three elements of control, then an investor should reassess whether it controls an investee.

In most cases, the parent has control because they own a majority of the ordinary shares in the subsidiary (to which normal voting rights are attached). There are circumstances, however, when the parent owns only a minority of the voting power in the subsidiary, *but* still has control because it has:

- rights to appoint, reassign or remove key management personnel who can direct the relevant activities;
- rights to appoint or remove another entity that directs the relevant activities;
- rights to direct the investee to enter into, or veto changes to, transactions for the benefit of the investor; and
- other rights, such as those specified in a management contract.

An entity's **relevant activities** are those which significantly affect its profits or losses (an investor's returns), normally its trading, operating and financial activities.

If a parent has invested in a subsidiary it normally expects to obtain some kind of **return** on its investment. The key point here is that the return must have the **potential to vary** as a result of the investee's performance. If an investor has control over an investee, the amount of the return that it receives depends on the investee's results.

2.2.1 ACCOUNTING TREATMENT IN GROUP FINANCIAL STATEMENTS

IFRS 10 requires a parent to present consolidated financial statements, in which the accounts of the parent and subsidiary (or subsidiaries) are combined and presented **as a single entity**.

2.3 INVESTMENTS IN ASSOCIATES

This type of investment is something less than a subsidiary, but more than a simple investment. The key criterion here is **significant influence**. This is defined as the 'power to participate', but *not* to 'control' (which would make the investment a subsidiary).

Significant influence can be determined by the holding of voting rights (usually attached to ordinary shares) in the entity. IAS 28 states that if an investor holds **20 per cent or more** of the voting power of the investee, it is presumed that the investor has significant influence over the investee, *unless* it can be clearly shown that this is not the case.

Significant influence can be presumed *not* to exist if the investor holds **less than 20 per cent** of the voting power of the investee, unless it can be demonstrated otherwise.

The **existence of significant influence** is evidenced in one or more of the following ways:

- representation on the **board of directors** (or equivalent) of the investee;
- participation in the **policy making process**;
- **material transactions** between investor and investee;
- interchange of management personnel; and/or
- provision of essential technical information.

2.3.1 ACCOUNTING TREATMENT IN GROUP FINANCIAL STATEMENTS

IAS 28 requires use of the **equity method** of accounting for investments in associates. This method will be explained in detail later on in this module.

Question 1: Treatments

The section summary after this question gives an augmented version of the table given in section 2 above. Before you look at it, see if you can write out the table yourself.

(The answer is at the end of the module.)

2.4 SECTION SUMMARY

INVESTMENT	CRITERIA	REQUIRED TREATMENT IN GROUP ACCOUNTS
Subsidiary	Control (> 50 per cent rule)	Full consolidation (IFRS 10)
Associate	Significant influence (20 per cent + rule)	Equity accounting (IAS 28)
Investment which is neither of the above	No significant influence (< 20 per cent rule)	As for single company accounts

3 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

Section overview

- IFRS 10 requires a parent to present **consolidated** financial statements.

3.1 SUBJECT OUTLINE

Definition

Consolidated financial statements. The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. (IFRS 10)

When a parent issues consolidated financial statements, it consolidates **all subsidiaries**, both foreign and domestic. IFRS 10 provides guidance on the mechanics of consolidation including exemptions from consolidation, the use of uniform accounting policies, matching reporting dates and the elimination of intra-group transactions.

3.2 EXEMPTION FROM PREPARING GROUP ACCOUNTS

A parent **need not present** consolidated financial statements if and only if **all** of the following hold:

- the parent is itself a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
- its securities are **not publicly traded**;
- it is **not in the process of issuing securities** in public securities markets; and
- the **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards.

A parent that does not present consolidated financial statements must comply with the IAS 27 rules on separate financial statements.

3.3 EXCLUSION OF A SUBSIDIARY FROM CONSOLIDATION

A parent must include **all** entities that it controls in its consolidated financial statements.

The rules on exclusion of subsidiaries from consolidation are necessarily strict, because in the past this was a common method used by entities to manipulate their results. If a subsidiary which carries a large amount of debt can be excluded, then the gearing of the group as a whole will be improved. In other words, this is a way of taking debt **out of the statement of financial position**.

3.4 UNIFORM ACCOUNTING POLICIES

Consolidated financial statements are prepared using **the same accounting policies** for like transactions and other events in similar circumstances.

Adjustments must be made where members of a group use different accounting policies, so that their financial statements are suitable for consolidation.

3.5 DIFFERENT REPORTING DATES

In most cases, all group companies will prepare accounts to the same reporting date. One or more subsidiaries may, however, prepare accounts to a different reporting date from the parent and the bulk of other subsidiaries in the group.

In such cases the subsidiary may prepare additional statements to the reporting date of the rest of the group, for consolidation purposes. If this is not possible, the subsidiary's accounts may still be used for the consolidation, **provided that** the gap between the reporting dates is **three months or less**.

Where a subsidiary's accounts are drawn up to a different accounting date, **adjustments should be made** for the effects of significant transactions or other events that occur between that date and the parent's reporting date.

3.6 DATE OF INCLUSION OR EXCLUSION

The results of subsidiaries are included in the consolidated financial statements from:

- the date the parent obtains control, to
- the date the investor loses control.

Once an investment is no longer a subsidiary, it should be treated as an associate under IAS 28 (if applicable) or as an investment under IFRS 9 (**outside the scope** of the Financial Accounting and Reporting syllabus) as appropriate.

3.7 ACCOUNTING FOR SUBSIDIARIES AND ASSOCIATES IN THE PARENT'S SEPARATE FINANCIAL STATEMENTS

Parent company financial statements are no longer required in Australia. Where a parent company does not prepare separate financial statements, the Corporations Law requires various disclosures in the notes to the consolidated financial statements about the parent company.

Where a parent company chooses to produce its own separate financial statements (single company financial statements) these are prepared in accordance with IAS 27 *Separate Financial Statements*.

In a parent's separate financial statements, investments in subsidiaries and associates included in the consolidated financial statements are **either**:

- accounted for at **cost**, **or**
- in accordance with **IFRS 9** (**outside the scope** of the Financial Accounting and Reporting syllabus).

An entity should apply the same accounting treatment for each category of investments.

The parent recognises dividends from a subsidiary or an associate in profit or loss when its right to receive the dividend is established.

4 INTRA-GROUP TRANSACTIONS

LO 5.6

Section overview

- It is common for parent companies to transact with their subsidiaries. These transactions should not be reflected in the consolidated accounts.

One of the reasons why groups grow and companies acquire other companies is vertical integration where a company acquires its suppliers or customers. Therefore, it follows that intra-group or intercompany transactions are commonplace within groups. One group company may sell goods to another, or one company provides funding for others. Equally, where a subsidiary pays a dividend to its shareholders, some, or all of this amount is due to the parent company.

These transactions between group companies are (quite rightly) represented in the companies' individual accounts. When preparing the group accounts, however, it must be remembered that they present the group as a single economic entity. One entity is unable to trade with itself or lend to itself, and therefore the effects of intra-group transactions must be eliminated on consolidation. The mechanics of this are covered later in this module.

The net result is that the group accounts only include the effects of transactions between the group companies and third parties outside the group.

KEY MODULE POINTS 1

- The parent or holding company of a group owns some or all of the shares in the other companies.
- The information contained in the individual financial statements of a parent company and each of its investee companies does not give a picture of the group's total activities. Therefore, group financial statements must be prepared from the individual ones.
- A subsidiary is an entity that is controlled by the parent company. Control can usually be assumed to exist when the parent owns over 50 per cent of the voting power of an entity.
- Subsidiaries are consolidated in the group financial statements.
- A parent company has significant influence over an associate. Significant influence is normally assumed to exist where the parent owns at least 20 per cent of the voting power of an entity.
- Associates are equity accounted within the group financial statements.
- Where a parent company has neither control nor significant influence over an investee, the investment is recognised in group financial statements in the same way as in the parent's individual accounts.
- Consolidated financial statements are prepared from parent and subsidiary accounts which use the same accounting policies for like transactions and other events in similar circumstances.
- Consolidated financial statements are prepared from parent and subsidiary accounts prepared to the same reporting date. If this is not possible, the subsidiary's accounts may still be used for the consolidation, provided that the gap between the reporting dates is three months or less.
- It is common for parent companies to transact with their subsidiaries. These transactions should not be reflected in the consolidated financial statements.

QUICK REVISION QUESTIONS 1

1 During the last three years Harvert Co. has held 400 000 ordinary shares in Jamee Co. The issued share capital of Jamee Co. is 1 million shares totalling $500 000. The finance director of Harvert Co. is a director of Jamee Co.

How should the investment in Jamee Co. be treated in the consolidated financial statements of Harvert Co.?

A as a subsidiary
B as an associate
C as a current asset investment
D as a non-current asset investment

2 A owns 51 per cent of the voting shares in B and 100 per cent of the voting shares in D. B owns 25 per cent of the voting shares in C and has board representation in that company.

All holdings have been held for a number of years.

Which of the following statements is correct?

A B, C and D are subsidiaries of A
B B and D are subsidiaries of A while C is a subsidiary of B
C B and D are subsidiaries of A while C is an associate of B
D D is a subsidiary of A while B and C are investments of A

3 Which **one** of the following is a valid reason for excluding a 75 per cent owned company from consolidation under current International Financial Reporting Standards?

A The company operates in a hyperinflationary environment.
B A formally documented decision has been made by the directors to wind down the activities of the company.
C The activities of the company are dissimilar from those of the rest of the group so that it would be confusing to include it in the consolidation.
D The company operates in a country where the government has recently passed a law to obtain the power to govern the financial and operating policies of all entities.

4 Which of the following provide evidence of a parent-subsidiary relationship?

I. The parent has representation on the board of directors.
II. The parent has power to direct the operating activities of the entity by statute.
III. The parent has the power to remove a majority of members of the board of directors.
IV. The parent has power over more than 50 per cent of the voting rights through agreement with other investors.

A IV only
B I and IV only
C II, III and IV only
D I, II, III and IV

5 During the last financial year, Orius Co. acquired 44 per cent of the issued share capital of Eerus Co. Under the terms of the acquisition, the finance director of Orius was appointed to the board of directors of Eerus.

Which of the following correctly describes how Orius should account for its interest in Eerus in the consolidated financial statements?

A as a subsidiary, using equity accounting
B as an associate, using equity accounting
C as a subsidiary, using consolidation accounting
D as an associate, using consolidation accounting

6 Which of the following provides evidence of a situation where the investee should be accounted for using the equity method?

A a shareholding of 18 per cent in the investee

B provision of operational personnel by the parent to the investee

C provision of essential technical information by the parent to the investee

D the parent has the power to govern the financial policies of the investee by agreement

7 Where a subsidiary does not prepare accounts to the same date as the parent company, which of the following is correct?

A Additional financial statements must be prepared to the group reporting date by the subsidiary.

B The subsidiary's accounts may be used for the consolidation provided that the gap between the reporting dates is three months or less.

C The subsidiary's accounts may be used for the consolidation provided that they are prepared to a date within three months after the end of the group reporting period.

D The subsidiary's accounts may be used for the consolidation provided that they are prepared to a date within three months before the end of the group reporting period.

8 Which of the following statements are correct?

I. Intra-group transactions must be eliminated on consolidation.

II. Where a group comprises a parent company and an investee over which the parent has significant influence, consolidated accounts must be prepared.

III. A holding of 10 per cent of ordinary voting shares in another company must be accounted for in accordance with IAS 28 *Investments in Associates and Joint Ventures*.

IV. Where a subsidiary does not adopt the same accounting policies as its parent company, adjustments must be made to bring its accounting policies into line prior to consolidation.

A I and II only

B I and IV only

C III and IV only

D I, II, III and IV

5 NON-CONTROLLING INTERESTS

LO 5.4

Section overview

- The consolidated statement of financial position shows non-controlling interest as a separate item in equity.

5.1 SUBJECT OUTLINE

It was mentioned earlier that the total assets and liabilities of subsidiary companies are included in the consolidated statement of financial position, even if the subsidiaries are not wholly owned by the parent. A proportion of the net assets of such subsidiaries in fact belongs to investors from outside the group (**non-controlling interests**).

IFRS 3 allows two alternative ways of measuring the non-controlling interest at acquisition:

(a) as a proportionate share of the fair value of the subsidiary's net assets; or

(b) at fair value (based on the market value of the shares held by the non-controlling interest).

Regardless of the measurement method used, the non-controlling interest reported in the consolidated statement of financial position at subsequent reporting dates is increased by the non-controlling interest's share of profits made by the subsidiary since acquisition.

Exam comments

For the purposes of the exam, you are required to be able to apply both measurement methods.

The following example shows non-controlling interest calculated as a proportionate share of the fair value of the subsidiary's net assets.

Worked Example: Non-controlling interests

P Co. has owned 75 per cent of the share capital of S Co. since the date of S Co.'s incorporation. Their latest statements of financial position are given below.

P CO.
STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Non-current assets		
Property, plant and equipment	50 000	
30 000 ordinary shares in S Co. at cost	30 000	
		80 000
Current assets		45 000
Total assets		125 000
Equity and liabilities		
Equity		
80 000 ordinary shares	80 000	
Retained earnings	25 000	
		105 000
Current liabilities		20 000
Total equity and liabilities		125 000

S CO.
STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Property, plant and equipment		35 000
Current assets		35 000
Total assets		70 000
Equity and liabilities		
Equity		
40 000 ordinary shares	40 000	
Retained earnings	10 000	
		50 000
Current liabilities		20 000
Total equity and liabilities		70 000

Required

Prepare the consolidated statement of financial position. P Co.'s accounting policy is to measure non-controlling interest at acquisition as a proportional share of the subsidiary's net assets.

Solution

All of S Co.'s net assets are consolidated despite the fact that the company is only 75 per cent owned. The amount of net assets attributable to non-controlling interests is calculated as follows:

	$
Non-controlling interest at acquisition:	
Non-controlling share of share capital (25% × $40 000)	10 000
Non-controlling share of S Co.'s profits since acquisition:	
Non-controlling share of retained earnings (25% × $10 000)	2 500
	12 500

Of S Co.'s share capital of $40 000, $10 000 is included in the figure for non-controlling interest, while $30 000 is cancelled with P Co.'s asset 'investment in S Co.'.

Of S Co.'s retained earnings of $10 000, $2500 is included in the figure for non-controlling interest, while $7500 'belongs' to the group and so is included in group retained earnings in the consolidated statement of financial position.

The consolidated statement of financial position can now be prepared.

P GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Property, plant and equipment		85 000
Current assets		80 000
Total assets		165 000
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	80 000	
Retained earnings $(25 000 + (75% × $10 000))	32 500	
		112 500
Non-controlling interest		12 500
		125 000
Current liabilities		40 000
Total equity and liabilities		165 000

5.2 PROCEDURE IN SUMMARY

1. Aggregate the assets and liabilities in the statement of financial position i.e. 100 per cent P + 100 per cent S irrespective of how much P actually owns.
   This shows the amount of net assets **controlled** by the group.
2. Share capital is that of the parent only.
3. Calculate the non-controlling interest share of the fair value of the subsidiary's net assets (share capital plus retained earnings plus any other reserves).
4. The balance of the subsidiary's retained earnings and other reserves are consolidated (after cancelling any intra-group items).

Question 2: Part cancellation

Set out below are the draft statements of financial position of P Co. and its subsidiary S Co. You are required to prepare the consolidated statement of financial position. The non-controlling interest is valued at its proportional share of the fair value of the subsidiary's net assets.

P CO.

	$	$
Assets		
Non-current assets		
Property, plant and equipment		31 000
Investment in S Co.		
12 000 ordinary shares at cost	12 000	
$8 000 10% loan at cost	8 000	
		20 000
		51 000
Current assets		21 000
Total assets		72 000
Equity and liabilities		
Equity		
40 000 ordinary shares	40 000	
Retained earnings	22 000	
		62 000
Current liabilities		10 000
Total equity and liabilities		72 000

S CO.

	$	$
Assets		
Property, plant and equipment		34 000
Current assets		32 000
Total assets		66 000
Equity and liabilities		
Equity		
20 000 ordinary shares	20 000	
Revaluation surplus	6 000	
Retained earnings	4 000	
		30 000
Non-current liabilities		
10% loan stock		26 000
Current liabilities		10 000
Total equity and liabilities		66 000

(The answer is at the end of the module.)

Question 3: Non-controlling interest

Pam Co. acquired 90 per cent of the ordinary voting shares in Sam Co. on 1 March 20X7 for $5.6 million. At that date the fair value of a 10 per cent holding in Sam Co. was $460 000. Sam Co. has made the following profits since acquisition:

– $275 400 in the year ended 28 February 20X8
– $286 000 in the year ended 28 February 20X9

The net assets of Sam Co. at 28 February 20X9 are $5.56 million and the fair value of a 10 per cent shareholding at that date based on market values is $520 000. What is the non-controlling interest in the Pam Co. Consolidated Statement of Financial Position at 28 February 20X9 assuming that it is group policy to apply the fair value method of measurement of non-controlling interest?

A $516 140
B $520 000
C $556 000
D $1 016 000

(The answer is at the end of the module.)

6 GOODWILL ARISING ON CONSOLIDATION

LOs 5.2, 5.3, 5.4

Section overview

- Goodwill arises where the consideration transferred by the parent company is not equal to the group share of the net assets of the subsidiary at acquisition.

6.1 ACCOUNTING FOR THE PURCHASE OF SHARES IN A SUBSIDIARY

When a company P Co. **purchases shares** in a company S Co. it pays money or gives other purchase consideration to the previous owners of those shares. Suppose P Co. purchases all 40 000 shares in S Co. and pays $60 000 cash to the previous shareholders. The entries in P Co.'s books would be:

Dr.	Investment in S Co. at cost	$60 000	
Cr.	Bank		$60 000

However, the previous shareholders might be prepared to accept some other form of consideration. For example, they might accept an agreed number of **shares** in P Co. P Co. issues new shares and gives them to the former shareholders of S Co. This might be attractive to P Co. because it avoids a heavy cash outlay. The former shareholders of S Co. retain an indirect interest in S Co.'s profitability via their new holding in its parent company.

Continuing the example, suppose that instead of $60 000 cash for all 40 000 shares the shareholders of S Co. agreed to accept one ordinary share in P Co. for every two ordinary shares in S Co., because the market value of P Co.'s shares is $3 per share. P Co. issues 20 000 new shares. How would this transaction be recorded in the books of P Co.?

Dr.	Investment in S Co. (20 000 × $3)	$60 000	
Cr.	Share capital		$60 000

The amount which P Co. pays and records in its books as the cost of its investment in S Co. may be more or less than the book value of the assets it acquires. Suppose that S Co. in the previous example has nil reserves and nil liabilities, so that its share capital of $40 000 is balanced by tangible non-current assets with a book value of $40 000. For simplicity, assume that the book value of S Co.'s assets is the same as their fair value.

Now, if the directors of P Co. agree to pay $60 000 for a 100 per cent investment in S Co. they must believe that, in addition to its tangible non-current assets of $40 000, S Co. must also have intangible assets worth $20 000. This amount of $20 000 paid over and above the value of the tangible net assets acquired is called **goodwill arising on consolidation** (sometimes called **premium on acquisition**).

Following the normal cancellation procedure the $40 000 share capital in S Co.'s statement of financial position is cancelled against $40 000 of the 'investment in S Co.' in the statement of financial position of P Co. This leaves a $20 000 debit uncancelled in the parent company's accounts and this $20 000 appears in the consolidated statement of financial position as 'Intangible non-current assets: goodwill arising on consolidation'.

Goodwill arising on consolidation is not amortised; it is subject to an annual impairment review.

6.2 GOODWILL AND PRE-ACQUISITION PROFITS

Up to now we have assumed that S Co. had nil retained earnings when its shares were purchased by P Co. Assuming instead that S Co. had earned profits of $8000 in the period before acquisition, its statement of financial position just before the purchase would look as follows:

	$
Total assets	48 000
Share capital	40 000
Retained earnings	8 000
	48 000

If P Co. pays $60 000 to purchases all the shares in S Co. it has acquired total assets worth $48 000 and clearly, S Co.'s intangible assets (goodwill) are being valued at $12 000. It should be apparent that any earnings retained by the subsidiary **prior to its acquisition** by the parent company are **incorporated in the cancellation** process to arrive at a figure for goodwill. In other words, not only S Co.'s share capital, but also its **pre-acquisition** retained earnings, are cancelled against the asset 'investment in S Co.' in the accounts of the parent company. The uncancelled balance of $12 000 is goodwill in the consolidated statement of financial position.

The consequence of this is that **any pre-acquisition retained earnings of a subsidiary are not aggregated with the parent's retained earnings** in the consolidated statement of financial position. The figure of consolidated retained earnings comprises the retained earnings of the parent plus the **post-acquisition retained earnings only of subsidiaries**. The post-acquisition retained earnings are simply retained earnings now *less* retained earnings at acquisition.

Worked Example: Goodwill and pre-acquisition profits

Sing Co. acquired all of the ordinary shares of Wing Co. on 31 March, immediately after which the draft statements of financial position of each company were as follows:

SING CO.
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	$
Assets	
Non-current assets	
Investment in 50 000 shares of Wing Co. at cost	80 000
Current assets	40 000
Total assets	120 000
Equity and liabilities	
Equity	
Ordinary shares	75 000
Retained earnings	45 000
Total equity and liabilities	120 000

WING CO.
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	$
Current assets	60 000
Equity	
50 000 ordinary shares	50 000
Retained earnings	10 000
	60 000

Prepare the consolidated statement of financial position as at 31 March.

Solution

The technique to adopt here is to produce a new working: 'Goodwill'. A proforma working is set out below:

Goodwill

	$	$
Consideration transferred		X
Net assets acquired as represented by:		
Ordinary share capital	X	
Retained earnings on acquisition	X	
		(X)
Goodwill		X

Applying this to our example the working will look like this:

	$	$
Consideration transferred		80 000
Net assets acquired as represented by:		
Ordinary share capital	50 000	
Retained earnings on acquisition	10 000	
		(60 000)
Goodwill		20 000

SING CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	$
Assets	
Non-current assets	
Goodwill arising on consolidation (W)	20 000
Current assets (40 000 + 60 000)	100 000
	120 000
Equity	
Ordinary shares	75 000
Retained earnings	45 000
	120 000

Worked Example: Goodwill and pre-acquisition losses

Suppose P Co. acquired all the $50 000 issued ordinary shares in S Co. for $20 000 on 1 January 20X1 when there was a debit balance of $35 000 on S Co.'s retained earnings. In the years 20X1 to 20X4 S Co. makes profits of $40 000 in total, leaving a credit balance of $5000 on retained earnings at 31 December 20X4. P Co.'s retained earnings at the same date are $70 000.

Calculate the values of goodwill and retained earnings in the consolidated statement of financial position at 31 December 20X4.

Solution

The consolidation workings are:

1 *Goodwill*

	$	$
Consideration transferred		20 000
Net assets acquired as represented by		
Ordinary share capital	50 000	
Retained earnings	(35 000)	
		(15 000)
Goodwill		5 000

2 *Retained earnings*

	P Co. $	S Co. $
At the end of the reporting period	70 000	5 000
Pre-acquisition loss		35 000
		40 000
S Co. – share of post-acquisition retained earnings (40 000 × 100%)	40 000	
	110 000	

6.3 GOODWILL AND NON-CONTROLLING INTEREST AT A PROPORTION OF FAIR VALUE OF NET ASSETS

Now let us look at what would happen if Sing Co. had obtained less than 100 per cent of the shares of Wing Co.

If Sing Co. had paid $70 000 for 40 000 shares in Wing Co. (80 per cent), the goodwill calculation includes the non-controlling interest. We'll assume that it is group policy to measure the NCI as a proportion of net assets in the subsidiary.

Therefore:

	$
Consideration transferred	70 000
Non-controlling interest at acquisition (60 000 × 20%)	12 000
	82 000
Fair value of net assets acquired	(60 000)
Goodwill	22 000

6.4 GOODWILL AND NON-CONTROLLING INTEREST AT FAIR VALUE

As we have seen, IFRS 3 gives companies the option of valuing the non-controlling interest (NCI) at acquisition at fair value. The thinking behind this is that the non-controlling interest also owns some of the goodwill in the subsidiary, and that the traditional method of consolidation does not show this goodwill.

IFRS 3 suggests that the closest approximation to fair value is the market price of the shares held by non-controlling shareholders just before acquisition by the parent.

Continuing our example above, we will assume that the market price of the shares was $1.25. The goodwill calculation will then be as follows:

	$
Consideration transferred	70 000
Non-controlling interest at acquisition (10 000 × $1.25)	12 500
	82 500
Fair value of net assets acquired	(60 000)
Goodwill	22 500

Goodwill (total $22 500) is $500 higher than the goodwill calculated by measuring the non-controlling interest at its share of the net assets of the subsidiary. This $500 represents the **goodwill attributable to the non-controlling interest**. This can be seen to better effect if the calculation is laid out slightly differently, as follows:

	Group	NCI
	$	$
Consideration transferred/fair value of NCI (10 000 × $1.25)	70 000	12 500
Net assets at acquisition – Group/NCI share	(48 000)	(12 000)
Goodwill	22 000	500

6.5 NON-CONTROLLING INTEREST AT YEAR END

As we have seen, the non-controlling interest at the year end is measured as:

NCI at acquisition	X
NCI share of fair value of post-acquisition profits of subsidiary	X
	X

Where the non-controlling interest is measured as a proportion of the fair value of the net assets of the subsidiary, a simpler way to calculate the NCI at a given date is by taking the NCI's share of the fair value of the net assets of the subsidiary at that date.

Where the non-controlling interest is measured at fair value at acquisition, an alternative calculation of the NCI at a given reporting date is:

NCI share of fair value of net assets of S at reporting date	X
NCI goodwill on acquisition	X
	X

Worked Example: Consolidated statement of financial position

P acquired 75 per cent of the 50 000 shares in S on 1 January 20X7 when S had retained earnings of $15 000. The market price of S's shares just before the date of acquisition was $1.60. P values the non-controlling interest at fair value. Goodwill is not impaired.

The statements of financial position of P and S at 31 December 20X7 were as follows:

	P	S
	$	$
Property, plant and equipment	60 000	50 000
Shares in S	68 000	–
	128 000	50 000
Current assets	52 000	35 000
	180 000	85 000
Share capital	100 000	50 000
Retained earnings	70 000	25 000
	170 000	75 000
Current liabilities	10 000	10 000
	180 000	85 000

Prepare the consolidated statement of financial position of the P Group as at 31 December 20X7.

Solution

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X7

	$
Assets	
Property, plant and equipment (60 000 + 50 000)	110 000
Goodwill (W1)	23 000
Current assets (52 000 + 35 000)	87 000
Total assets	220 000
Equity and liabilities	
Equity attributable to the owners of P	
Share capital	100 000
Retained earnings (W2)	77 500
	177 500
Non-controlling interest (W3)	22 500
Total equity	200 000
Current liabilities (10 000 + 10 000)	20 000
Total equity and liabilities	220 000

Workings

1 *Goodwill*

	Group	NCI
	$	$
Consideration transferred/fair value of NCI (12 500 × $1.60)	68 000	20 000
Net assets of S at acquisition (50 000 + 15 000) Group / NCI share	(48 750)	(16 250)
Goodwill (parent and non-controlling interest)	19 250	3 750

2 *Retained earnings*

	P	S
	$	$
Per statement of financial position	70 000	25 000
Less pre-acquisition		(15 000)
		10 000
Group share of S (10 000 × 75%)	7 500	
Group retained earnings	77 500	

3 *Non-controlling interest at year end*

	$
Share of net assets of S (75 000 × 25%)	18 750
Goodwill (W1)	3 750
	22 500

6.6 EFFECT OF NON-CONTROLLING INTEREST AT FAIR VALUE

You can see from the above example that the use of the fair value option increases goodwill and non-controlling interest by the same amount. That amount represents goodwill attributable to the shares held by non-controlling shareholders. It is not necessarily proportionate to the goodwill attributed to the parent. The parent may have paid proportionately more to acquire a controlling interest. If non-controlling interest was valued under the usual method (share of net assets) goodwill and non-controlling interest in the example above would be as follows:

W1 *Goodwill*

	$
Consideration transferred	68 000
Non-controlling interest ((50 000 + 15 000) × 25%)	16 250
Fair value of net assets of S at acquisition (50 000 + 15 000)	(65 000)
	19 250

W3 *Non-controlling interest at year end*

	$
Share of net assets of S (75 000 × 25%)	18 750

Compare these with goodwill and non-controlling interest in the solution above and you will see that both have been reduced by $3750 – the goodwill attributable to the non-controlling interest. So whether non-controlling interest is valued at share of fair value of net assets or at fair value, the statement of financial position will still balance.

6.7 IMPAIRMENT OF GOODWILL

Goodwill arising on consolidation is subject to an annual impairment review, and impairment may be expressed as an amount or as a percentage. The double entry to write off the impairment is:

Dr. Group retained earnings *Cr.* Goodwill

However, when non-controlling interest is valued at **fair value** the goodwill in the statement of financial position includes goodwill attributable to the non-controlling interest. In this case the double entry will reflect the non-controlling interest proportion based on their shareholding as follows:

Dr. Group retained earnings *Cr.* Goodwill
Dr. Non-controlling interest

In our solution above in 6.5 the non-controlling interest holds 25 per cent. If the total goodwill of $23 000 was impaired by 20 per cent or $4600, the double entry for this would be:

	$		$
Dr. Retained earnings	3 450	*Cr.* Goodwill	4 600
Dr. Non-controlling interest	1 150		

The non-controlling interest at the year end would then be $21 350.

6.8 GAIN ON A BARGAIN PURCHASE

Goodwill arising on consolidation is the difference between the cost of an acquisition plus the non-controlling interest and the value of the subsidiary's net assets. This difference can be **negative**. IFRS 3 refers to this as a 'bargain purchase'. In this situation:

1. The acquirer should first **re-assess** the amounts at which it has measured both the cost of the combination and the acquiree's identifiable net assets. This exercise should **identify any errors**.
2. Any **excess remaining** is **recognised immediately in profit or loss**.

6.9 DEFERRED OR CONTINGENT CONSIDERATION

An acquirer measures the cost of an investment in a subsidiary as the total of the **fair values**, at the date of acquisition, **of assets transferred by the acquirer**, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree.

Where equity instruments (e.g. ordinary shares) of a quoted company form part of the consideration, the **published price** at the date of exchange provides the best evidence of the instrument's fair value.

Sometimes all or part of the cost of an acquisition is deferred (i.e. does not become payable immediately). Sometimes the deferred payment is also contingent (i.e. will only be paid if certain conditions are fulfilled).

6.9.1 CONTINGENT CONSIDERATION

The parent company could agree that some of the consideration is withheld and paid only if future stated conditions are fulfilled. For example, P Co. acquires 60 per cent of S Co.'s $100m share capital on 1 January 20X6 for a cash payment of $150m and a further payment of $50m on 31 March 20X7 **if** the subsidiary's post-acquisition profits have exceeded $50m by that date.

IFRS 3 requires the acquisition-date **fair value** of contingent consideration to be recognised as part of the consideration. In an examination question candidates will be told the acquisition-date fair value or told how to calculate it.

6.9.2 DEFERRED CONSIDERATION

An agreement may be made that part of the consideration for the combination will be paid at a future date. This consideration is discounted to its present value using the acquiring company's cost of capital.

For example, P Co. acquires 75 per cent of S Co.'s 80m shares on 1 January 20X6. It paid $3.50 per share and agreed to pay a further $108m on 1 January 20X7.

P Co.'s cost of capital is 8 per cent.

In the financial statements for the year to 31 December 20X6 the cost of the combination will be:

	$m
80m shares × 75% × $3.50	210
Deferred consideration:	
$108m × 1 / 1.08	100
Total consideration	310

In P Co.'s books the transaction is recorded as:

Dr.	Investment in subsidiary	$310m	
Cr.	Cash		$210m
Cr.	Liability		$100m

At 31 December 20X6, the cost of the investment will be unchanged but $8m will be charged as finance costs and added to the carrying amount of the liability to unwind the discount on the deferred consideration.

6.9.3 EXPENSES AND ISSUE COSTS

Expenses of the acquisition, such as lawyers' and accountants' fees are written off to profit or loss as incurred. However, IFRS 3 requires that the costs of issuing equity are debited to the share capital account.

Worked Example: Cost of a business combination

Tyzo Co. has just acquired 100 per cent of Kono Co., a company with net assets of $9.9m valued at fair value.

Rather than pay cash for Kono Co.'s shares, Tyzo has funded the acquisition by issuing 4.5m of its own shares to Kono Co.'s shareholders.

Tyzo's shares have a market value of $3. The costs of the share issue amounted to $500 000 and Tyzo paid a total of $750 000 to lawyers and accountants to carry out the combination.

Calculate the goodwill.

Solution

	$m
Consideration:	
Share issue (4.5m × $3)	13.5
Net assets acquired	(9.9)
Goodwill	3.6

Note: The share issue costs are debited to share capital and the $750 000 expenses are thereby written off.

6.10 GOODWILL DISCLOSURE

IFRS 3 requires that the following are disclosed in respect of acquired goodwill arising in the period:

- a qualitative description of the factors that make up the goodwill recognised;
- the acquisition-date fair value of the total consideration transferred split into each major class of consideration;
- the amounts recognised at the acquisition date for each major class of assets acquired and liabilities assumed;
- the amount of any gain recognised on a bargain purchase; and
- the amount of the non-controlling interest and the measurement basis used.

In subsequent years, a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period is required showing separately:

- impairment losses brought forward;
- additional goodwill recognised in the period;
- impairment losses recognised in the period;
- impairment losses carried forward; and
- any other changes in the carrying amount during the reporting period.

7 BASIC PRINCIPLES OF THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

LO 5.5

Section overview

- How are consolidated financial statements prepared? IFRS 10 lays out the basic procedures which we will follow in this module.

7.1 BASIC PROCEDURES

The preparation of a consolidated statement of financial position consists of two procedures:

- Take the individual accounts of the parent company and each subsidiary and **cancel out items** that appear as an asset in one company and a liability or equity in another.
- Add together all the uncancelled assets and liabilities throughout the group.

7.2 CANCELLATION

Items requiring cancellation include the following:

- The asset **'investment in subsidiary companies'** which appears in the parent company's accounts is matched with the liability (or equity) 'share capital and reserves' in the subsidiaries' accounts.
- There may be **intra-group trading** within the group. For example, S Co. may sell goods on credit to P Co. P Co. would then be a receivable in the accounts of S Co., while S Co. would be a payable in the accounts of P Co.

Worked Example: Cancellation

P Co. regularly sells goods to its one subsidiary company, S Co., which it has owned since S Co.'s incorporation. The statements of financial position of the two companies on 31 December 20X6 are given below.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6

	P Co.	S Co.
Assets	**$**	**$**
Non-current assets		
Property, plant and equipment	35 000	45 000
Investment in 40 000 shares in S Co. at cost	40 000	
	75 000	
Current assets		
Inventories	16 000	12 000
Receivables: S Co.	2 000	
Other	6 000	9 000
Cash at bank	1 000	
Total assets	100 000	66 000
Equity and liabilities		
Equity		
40 000 ordinary shares		40 000
70 000 ordinary shares	70 000	
Retained earnings	16 000	19 000
	86 000	59 000
Current liabilities		
Bank overdraft		3 000
Payables: P Co.		2 000
Other	14 000	2 000
Total equity and liabilities	100 000	66 000

Required

Prepare the consolidated statement of financial position of P Co. at 31 December 20X6.

Solution

The cancelling items are:

(a) P Co.'s asset 'investment in shares of S Co.' ($40 000) cancels with S Co.'s liability (equity) 'share capital' ($40 000);

(b) P Co.'s asset 'receivables: S Co.' ($2000) cancels with S Co.'s liability 'payables: P Co.' ($2000).

The remaining assets and liabilities are added together to produce the following consolidated statement of financial position.

P CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6

Assets	**$**	**$**
Non-current assets		
Property, plant and equipment		80 000
Current assets		
Inventories	28 000	
Receivables	15 000	
Cash at bank	1 000	
		44 000
Total assets		124 000
Equity and liabilities		
Equity		
70 000 ordinary shares	70 000	
Retained earnings	35 000	
		105 000
Current liabilities		
Bank overdraft	3 000	
Payables	16 000	
		19 000
Total equity and liabilities		124 000

Note the following:

- P Co.'s bank balance is **not netted off** with S Co.'s bank overdraft. To offset one against the other would be less informative and would conflict with the principle that assets and liabilities should not be netted off.
- The share capital in the consolidated statement of financial position is the **share capital of the parent company alone**. This must **always** be the case, no matter how complex the consolidation, because the share capital of subsidiary companies must **always** be a wholly cancelling item.

7.3 PART CANCELLATION

An item may appear in the statements of financial position of a parent and its subsidiary, but not at the same amounts:

- The parent company may have acquired **shares in the subsidiary** at a price **greater or less than the amount at which they are recorded in the accounts of the subsidiary**. The asset (investment) will appear in the parent's accounts at cost or fair value, while the liability (equity) will appear in the subsidiary's accounts at book value. This is **goodwill**, which is dealt with later in this module.
- The parent company **may not** have **acquired all the shares of the subsidiary** (so the subsidiary may be only partly owned). This is the **non-controlling interest**, which is dealt with later in this module.
- The inter-company trading balances may not be equal and opposite because of **goods or cash in transit**.
- One company may have purchased some, but not all, of the **issued loan capital** of the other company. This means that one company has given a loan to another, resulting in a receivable in one set of accounts and a payable in the other. Note that loan capital/loan stock is sometimes so called because it is 'sold' (i.e. loans raised) in units (of, say, $100) but it does not give rise to voting rights and so is not capital in the true sense.

The following question illustrates the techniques needed to deal with items (c) and (d) above.
The procedure is to **cancel as far as possible**. The remaining uncancelled amounts appear in the consolidated statement of financial position:

- **Uncancelled loan stock** will appear as a **liability of the group**.
- **Uncancelled balances on intra-group accounts** represent **goods or cash in transit**, which will appear in the consolidated statement of financial position.

Question 4: Cancellation

The statements of financial position of P Co. and of its subsidiary S Co. have been made up to 30 June. P Co. has owned all the ordinary shares and 40 per cent of the loan stock of S Co. since its incorporation.

P CO.
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	$	$
Assets		
Non-current assets		
Property, plant and equipment	120 000	
Investment in S Co., at cost		
80 000 ordinary shares	80 000	
$20 000 of 12% loan stock in S Co.	20 000	
		220 000
Current assets		
Inventories	50 000	
Receivables	40 000	
Current account with S Co.	18 000	
Cash	4 000	
		112 000

	$	$
Total assets		332 000
Equity and liabilities		
Equity		
Ordinary shares, fully paid	100 000	
Retained earnings	95 000	
		195 000
Non-current liabilities		
10% loan stock		75 000
Current liabilities		
Payables	47 000	
Taxation	15 000	
		62 000
Total equity and liabilities		332 000

S CO.
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	$	$
Non-current assets		
Property, plant and equipment		100 000
Current assets		
Inventories	60 000	
Receivables	30 000	
Cash	6 000	
		96 000
Total assets		196 000
Equity and liabilities		
Equity		
80 000 ordinary shares, fully paid	80 000	
Retained earnings	28 000	
		108 000
Non-current liabilities		
12% loan stock		50 000
Current liabilities		
Payables	16 000	
Taxation	10 000	
Current account with P Co.	12 000	
		38 000
Total equity and liabilities		196 000

The difference on current account arises because of goods in transit.

Required

Prepare the consolidated statement of financial position of P Co. as at 30 June.

(The answer is at the end of the module.)

8 COMPREHENSIVE EXAMPLE

Now we will look at a full consolidation question with the adjustments covered so far. Non-controlling interest is measured at the acquisition date at fair value.

Question 5: Consolidated statement of financial position

The draft statements of financial position of Ping Co. and Pong Co. on 30 June 20X8 were as follows:

PING CO.
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

	$	$
Assets		
Non-current assets		
Property, plant and equipment	50 000	
20 000 ordinary shares in Pong Co. at cost	30 000	
		80 000
Current assets		
Inventory	3 000	
Receivables	16 000	
Cash	2 000	
		21 000
Total assets		101 000
Equity and liabilities		
Equity		
45 000 Ordinary shares	45 000	
Revaluation surplus	12 000	
Retained earnings	26 000	
		83 000
Current liabilities		
Owed to Pong Co.	8 000	
Trade payables	10 000	
		18 000
Total equity and liabilities		101 000

PONG CO.
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

	$	$
Assets		
Property, plant and equipment		40 000
Current assets		
Inventory	8 000	
Owed by Ping Co.	10 000	
Receivables	7 000	
		25 000
Total assets		65 000
Equity and liabilities		
Equity		
25 000 Ordinary shares	25 000	
Revaluation surplus	5 000	
Retained earnings	28 000	
		58 000
Current liabilities		
Trade payables		7 000
Total equity and liabilities		65 000

Ping Co. acquired its investment in Pong Co. on 1 July 20X7 when the retained earnings of Pong Co. stood at $6000. The agreed consideration was $30 000 cash and a further $10 000 on 1 July 20X9 if Pong Co. attained certain anticipated profit targets. Ping Co.'s cost of capital is 7 per cent. Pong Co. has an internally-developed brand name – 'Pongo' – which was valued at $5000 at the date of

acquisition. There have been no changes in the share capital or revaluation surplus of Pong Co. since that date. At 30 June 20X8 Pong Co. had invoiced Ping Co. for goods to the value of $2000 which had not been received by Ping Co.

There is no impairment of goodwill. It is group policy to value non-controlling interest at full fair value. At the acquisition date the non-controlling interest was valued at $9000.

Prepare the consolidated statement of financial position of Ping Co. as at 30 June 20X8.

(The answer is at the end of the module.)

9 INTRA-GROUP TRADING

LO 5.6

Section overview

- Where one company in a group engages in trading with another group company any profit made is eliminated on consolidation.

9.1 UNREALISED PROFIT

Any receivable/payable balances outstanding between parent and subsidiary are cancelled on consolidation. No further problem arises if all such intra-group transactions are **undertaken at cost**, without any mark-up for profit.

However, each company in a group is a separate trading entity and may wish to treat other group companies in the same way as any other customer. In this case, a company (say A Co.) may buy goods at one price and sell them at a higher price to another group company (B Co.). The accounts of A Co. will quite properly include the profit earned on sales to B Co.; and similarly B Co.'s statement of financial position will include inventories at their cost to B Co., that is, at the amount at which they were purchased from A Co.

This gives rise to two problems:

- Although A Co. makes a profit as soon as it sells goods to B Co., the group does not make a sale or achieve a profit until an outside customer buys the goods from B Co.
- Any purchases from A Co. which remain unsold by B Co. at the year end will be included in B Co.'s inventory. Their value in the statement of financial position will be their cost to B Co., which is bigger than their cost to the group.

The objective of consolidated accounts is to present the financial position of several connected companies as that of a single entity, the group. This means that **in a consolidated statement of profit or loss the only profits recognised should be those earned by the group** in providing goods or services to outsiders. These are referred to as **realised profits**. Similarly, inventory in the consolidated statement of financial position should be valued at cost to the group.

Suppose that a holding company P Co. buys goods for $1600 and sells them to a wholly owned subsidiary S Co. for $2000. The goods are in S Co.'s inventory at the year end and appear in S Co.'s statement of financial position at $2000. P Co. will record a profit of $400 in its individual accounts, but from the group's point of view the figures are:

Cost	$1600
External sales	nil
Closing inventory at cost	$1600
Profit/loss	nil

If we add together the figures for retained earnings and inventory in the individual statements of financial position of P Co. and S Co. the resulting figures for consolidated retained earnings and consolidated inventory will each be overstated by $400. A **consolidation adjustment** is therefore necessary as follows:

Dr. Group retained earnings

Cr. Group inventory (statement of financial position)

with the amount of **profit unrealised** by the group.

Question 6: Unrealised profit

P Co. acquired all the 30 000 shares in S Co. one year ago when the reserves of S Co. stood at $10 000. Draft statements of financial position for each company are now as follows:

	P Co.		S Co.	
	$	$	$	$
Assets				
Non-current assets				
Property, plant and equipment	80 000			40 000
Investment in S Co. at cost	46 000			
		126 000		
Current assets		40 000		30 000
Total assets		166 000		70 000
Equity and liabilities				
Equity				
Ordinary shares	100 000		30 000	
Retained earnings	45 000		22 000	
		145 000		52 000
Current liabilities		21 000		18 000
Total equity and liabilities		166 000		70 000

During the year S Co. sold goods to P Co. for $50 000, the profit to S Co. being 20 per cent of selling price. At the end of the reporting period, $15 000 of these goods remained unsold in the inventories of P Co. At the same date, P Co. owed S Co. $12 000 for goods bought and this debt is included in the trade payables of P Co. and the receivables of S Co. The goodwill arising on consolidation has been impaired. The amount of the impairment is $1500.

Required

Prepare a draft consolidated statement of financial position for P Co.

(The answer is at the end of the module.)

9.2 NON-CONTROLLING INTERESTS IN UNREALISED INTRA-GROUP PROFITS

What if a subsidiary which is **not wholly owned is involved in intra-group trading** within the group? Suppose S Co. is 75 per cent owned and sells goods to its parent for $20 000 for which it paid $16 000, and these items are unsold by P Co. at the end of the reporting period. The 'unrealised' profit of $4000 earned by S Co. is partly owned by the non-controlling interest of S Co.

The correct treatment of these intra-group profits is to remove the whole profit, charging the non-controlling interest with their proportion.

Formula to learn

Dr.	Group retained earnings	with P's share of the unrealised profit
Dr.	Non-controlling interest	with NCI share of the unrealised profit
Cr.	Inventory (statement of financial position)	with the unrealised profit

Worked Example: Non-controlling interests and intra-group profits

P Co. has owned 75 per cent of the 100 000 shares of S Co. since the incorporation of S Co. During the year to 31 December 20X2, S Co. sold goods costing $16 000 to P Co. at a price of $20 000 and these goods were still unsold by P Co. at the end of the year. Draft statements of financial position of each company at 31 December 20X2 were as follows:

	P Co.		S Co.	
Assets	**$**	**$**	**$**	**$**
Non-current assets				
Property, plant and equipment	125 000		120 000	
Investment: 75 000 shares in S Co. at cost	75 000		–	
		200 000		120 000
Current assets				
Inventories	50 000		48 000	
Trade receivables	20 000		16 000	
		70 000		64 000
Total assets		270 000		184 000
Equity and liabilities				
Equity				
Ordinary shares	80 000		100 000	
Retained earnings	150 000		60 000	
		230 000		160 000
Current liabilities		40 000		24 000
Total equity and liabilities		270 000		184 000

Required

Prepare the consolidated statement of financial position of P Co. at 31 December 20X2. It is the group policy to measure the non-controlling interest at its proportionate share of the subsidiary's net assets.

Solution

The profit earned by S Co. but unrealised by the group is $4000 of which $3000 (75 per cent) is attributable to the group and $1000 (25 per cent) to the non-controlling interest. Remove the whole of the profit loading, charging the non-controlling interest with their proportion.

	P Co.	S Co.
	$	**$**
Retained earnings		
Per question	150 000	60 000
Less unrealised profit		(4 000)
		56 000
Share of S Co: $56 000 × 75%	42 000	
	192 000	
Non-controlling interest		
S Co.'s net assets (184 000 – 24 000)		160 000
Unrealised profit		(4 000)
		156 000
Non-controlling share (25%)		39 000

P CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

	$	$
Assets		
Property, plant and equipment		245 000
Current assets		
Inventories $(50 000 + 48 000 – 4000)	94 000	
Trade receivables	36 000	
		130 000
Total assets		375 000
Equity and liabilities		
Equity		
Ordinary shares	80 000	
Retained earnings	192 000	
		272 000
Non-controlling interest		39 000
		311 000
Current liabilities		64 000
Total equity and liabilities		375 000

10 INTRA-GROUP SALES OF NON-CURRENT ASSETS

LO 5.5

Section overview

- As well as engaging in trading activities with each other, group companies may on occasion **transfer non-current assets**.

10.1 ACCOUNTING TREATMENT

In their individual accounts the entities concerned will treat the transfer just like a sale between unconnected parties: the selling company will record a profit or loss on sale, while the purchasing company will record the asset at the amount paid to acquire it, and will use that amount as the basis for calculating depreciation.

On consolidation, the usual **'group entity' principle applies**. The consolidated statement of financial position must show assets at their net carrying amount (written down value) to the group, and any depreciation charged must be based on cost to the group. Two consolidation adjustments will usually be needed to achieve this.

(a) An adjustment to alter retained earnings and non-current assets net carrying amount to remove any element of unrealised profit or loss. This is similar to the adjustment required in respect of unrealised profit in inventory.

(b) An adjustment to alter retained earnings and accumulated depreciation so that consolidated depreciation is based on the asset's original cost to the group.

In practice, these steps are combined and the retained earnings of the company making the unrealised profit are debited with the unrealised profit less the additional depreciation.

The double entry is as follows.

(a) Sale by parent

Dr. Group retained earnings

Cr. Non-current assets

with the profit on disposal, less the additional depreciation.

(b) Sale by subsidiary

Dr. Group retained earnings (P's share)

Dr. Non-controlling interest (NCI's share)

Cr. Non-current assets

with the profit on disposal, less additional depreciation.

Worked Example: Intra-group sale of non-current assets

P Co. owns 60 per cent of S Co. and on 1 January 20X1 S Co. sells plant with a net carrying amount of $10 000 to P Co. for $12 500. The companies prepare accounts to 31 December 20X1 and the balances on their retained earnings at that date are:

P Co.	after charging depreciation of 10 per cent on plant	$27 000
S Co.	including profit on sale of plant	$18 000

Required

Show the working for consolidated retained earnings.

Solution

Retained earnings

	P Co. $	S Co. $
Per question	27 000	18 000
Disposal of plant		
Profit		(2 500)
Depreciation: 10% × $2 500		250
		15 750
Share of S Co.: $15 750 × 60%	9 450	
	36 450	

Notes

1 The non-controlling interest in the retained earnings of S Co. is 40% × $15 750 = $6 300.

2 The asset is written down to its net carrying amount at the date of transfer and depreciation on the 'profit' element is removed. The group profit for the year is thus reduced by a net (($2500 – $250) × 60%) = $1350.

11 SUMMARY: CONSOLIDATED STATEMENT OF FINANCIAL POSITION

PURPOSE	TO SHOW THE NET ASSETS WHICH P CONTROLS AND THE OWNERSHIP OF THOSE ASSETS.
Net assets	Always 100 per cent P plus 100 per cent S providing P holds a majority of voting rights.
Share capital	P only.
Reason	Simply reporting to the parent company's shareholders in another form.
Retained earnings	100 per cent P plus group share of post-acquisition retained earnings of S less consolidation adjustments.
Reason	To show the extent to which the group actually owns total assets less liabilities.
Non-controlling interest	NCI share of fair value of S's consolidated net assets, or fair value at acquisition plus share of subsequent profits.
Reason	To show the equity in a subsidiary not attributable to the parent.

12 ACQUISITION OF A SUBSIDIARY DURING ITS ACCOUNTING PERIOD

Section overview

- When a parent company acquires a subsidiary during its accounting period the only accounting entries made at the time will be those recording the **cost of acquisition in the parent company's books**.

12.1 ACCOUNTING PROBLEM

As we have seen, consolidated accounts are prepared at the end of the accounting year.

The subsidiary company's accounts show the subsidiary's profit or loss for the whole year. For consolidation, it will be necessary to distinguish between:

- profits earned before acquisition
- profits earned after acquisition

In practice, a subsidiary's profit may not accrue evenly over the year; for example, the subsidiary might be engaged in a trade, such as toy sales, with marked seasonal fluctuations. Nevertheless, the assumption can be made in the exam that **profits accrue evenly** to split pre- and post-acquisition profits.

Once the amount of pre-acquisition profit and thus the value of equity at acquisition has been established the appropriate consolidation workings (goodwill, retained earnings) can be produced.

Suppose the accounts of S Co., a 60 per cent subsidiary of P Co., show retained earnings of $20 000 at the end of the reporting period, of which $14 000 were earned prior to acquisition. The figure of $20 000 will appear in the consolidated statement of financial position as follows.

	$
Non-controlling interests: their share of total retained earnings at the end of the reporting period (40% × $20 000)	8 000
Goodwill: group share of pre-acquisition retained earnings (60% × $14 000)	8 400
Consolidated retained earnings: group share of post-acquisition retained earnings (60% × $6000)	3 600
	20 000

Question 7: Acquisition during the accounting period

Hinge Co. acquired 80 per cent of the 20 000 ordinary shares of Singe Co. on 1 April 20X5. On 31 December 20X4 Singe Co.'s accounts showed retained earnings of $19 000. The statements of financial position of the two companies at 31 December 20X5 are set out below. Neither company has paid any dividends during the year. Non-controlling interest should be valued at full fair value. The goodwill attributable to the non-controlling interest is valued at $3000.

You are required to prepare the consolidated statement of financial position of Hinge Co. at 31 December 20X5. There has been no impairment of goodwill.

HINGE CO
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$	$
Assets		
Non-current assets		
Property, plant and equipment	32 000	
16 000 ordinary shares in Singe Co	50 000	
		82 000
Current assets		85 000
Total assets		167 000
Equity and liabilities		
Equity		
Share capital	100 000	
Retained earnings	47 000	
		147 000
Current liabilities		20 000
Total equity and liabilities		167 000

SINGE CO
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$	$
Assets		
Property, plant and equipment		30 000
Current assets		43 000
Total assets		73 000
Equity and liabilities		
Equity		
Share capital	10 000	
Retained earnings	43 000	
		53 000
Current liabilities		20 000
Total equity and liabilities		73 000

(The answer is at the end of the module.)

13 FAIR VALUES IN ACQUISITION ACCOUNTING

Section overview

- An entity should adjust the subsidiary's accounts before consolidation to reflect the fair values of the assets and liabilities acquired.

13.1 GOODWILL

To understand the importance of fair values in the acquisition of a subsidiary consider what we mean by goodwill.

Definition

Goodwill. Any excess of the consideration transferred plus the non-controlling interest over the fair value of the identifiable assets and liabilities of the investee as at the date of the acquisition.

The **statement of financial position of a subsidiary** at the date it is acquired may not be a guide to the fair value of its net assets. For example, the market value of a freehold building may have risen greatly since it was acquired, but it is shown in the statement of financial position at historical cost less accumulated depreciation.

13.2 WHAT IS FAIR VALUE?

Fair value is defined as follows by IFRS 3 and various other standards – it is an important definition.

Definition

Fair value. 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.

13.3 FAIR VALUE ADJUSTMENT CALCULATIONS

So far in this module we have calculated goodwill based on the **book value** of net assets of the subsidiary. To comply with the definition above we must adjust the book value of the subsidiary's net assets to their **fair value**.

There are two possible ways of achieving this:

- The **subsidiary incorporates necessary revaluations** in its own financial records. In this case, we can proceed directly to the consolidation, taking asset values and reserves figures straight from the subsidiary's statement of financial position.
- The **revaluations** are not **incorporated** in the subsidiary's books. In this case, we must make the necessary adjustments to the subsidiary's statement of financial position as a working. Only then can we proceed to the consolidation.

Note: Remember that when depreciable assets are revalued there will be a corresponding alteration in the amount of depreciation charged and accumulated.

Worked Example: Fair value adjustments

P Co. acquired 75 per cent of the ordinary shares of S Co. on 1 September 20X5. At that date the fair value of S Co.'s non-current assets was $23 000 greater than their carrying amount, and the balance of retained earnings was $21 000. The statements of financial position of both companies at 31 August 20X6 are given below. S Co. has not incorporated any revaluation in its financial records. Non-controlling interest is valued at full fair value which was deemed to be $18 000 at the acquisition date.

P CO.
STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	$	$
Assets		
Non-current assets		
Property, plant and equipment	63 000	
Investment in S Co. at cost	51 000	
		114 000
Current assets		82 000
Total assets		196 000
Equity and liabilities		
Equity		
80 000 ordinary shares	80 000	
Retained earnings	96 000	
		176 000
Current liabilities		20 000
Total equity and liabilities		196 000

S CO
STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	$	$
Assets		
Property, plant and equipment		28 000
Current assets		43 000
Total assets		71 000
Equity and liabilities		
Equity		
Ordinary shares	20 000	
Retained earnings	41 000	
		61 000
Current liabilities		10 000
Total equity and liabilities		71 000

If S Co. had revalued its non-current assets at 1 September 20X5, an addition of $3000 would have been made to the depreciation charged for 20X5/X6.

Required

Prepare P Co.'s consolidated statement of financial position as at 31 August 20X6.

Solution

P CO. CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	$	$
Non-current assets		
Property, plant and equipment $(63 000 + 48 000)*	111 000	
Goodwill (W1)	5 000	
		116 000
Current assets		125 000
		241 000
Equity and liabilities		
Equity		
Ordinary shares	80 000	
Retained earnings (W2)	108 750	
		188 750
Non-controlling interest (W3)		22 250
		211 000
Current liabilities		30 000
		241 000

* (28 000 + 23 000 – 3000)

1 *Goodwill*

		Group	NCI
		$	$
Consideration transferred/fair value of NCI		51 000	18 000
Net assets acquired as represented by			
Ordinary share capital	20 000		
Retained earnings	21 000		
Fair value adjustment	23 000		
	64 000		
Group/NCI share		(48 000)	(16 000)
Goodwill		3 000	2 000

2 *Retained earnings*

	P Co. $	S Co. $
Per question	96 000	41 000
Pre-acquisition profits		(21 000)
Depreciation adjustment		(3 000)
Post-acquisition S Co.		17 000
Group share in S Co. ($17 000 × 75%)	12 750	
Group retained earnings	108 750	

3 *Non-controlling interest at reporting date*

	$
S Co.'s net assets (71 000 – 10 000)	61 000
Fair value adjustment (23 000 – 3 000)	20 000
	81 000
× 25%	20 250
Goodwill	2 000
	22 250

Question 8: Fair value

An asset is recorded in S Co.'s books at its historical cost of $4000. On 1 January 20X5 P Co. bought 80 per cent of S Co.'s equity. Its directors attributed a fair value of $3000 to the asset as at that date. It had been depreciated for two years out of an expected life of four years on the straight line basis. There was no expected residual value. On 30 June 20X5 the asset was sold for $2600. What is the profit or loss on disposal of this asset to be recorded in S Co.'s accounts and in P Co.'s consolidated accounts for the year ended 31 December 20X5?

(The answer is at the end of the module.)

13.4 FAIR VALUES OF IDENTIFIABLE ASSETS AND LIABILITIES NOT RECOGNISED BY THE ACQUIREE

IFRS 3 states that the acquirer should recognise the acquiree's identifiable assets acquired and liabilities assumed at the acquisition date, if they meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting*. This means:

- in the case of an **asset** it is **probable** that any associated **future economic benefits** will flow to the acquirer, and its fair value can be **measured reliably**
- in the case of a **liability** it is probable that an **outflow** of resources embodying economic benefits will be required to settle the obligation, and its fair value can be **measured reliably**.

The acquiree's identifiable assets and liabilities might include assets and liabilities **not previously recognised** in the acquiree's financial statements. For example, a tax benefit arising from the acquiree's tax losses that was not recognised by the acquiree may be recognised by the group if the acquirer has future taxable profits against which the unrecognised tax benefit can be applied. Also, IFRS 3 explains that an acquirer can recognise acquired identifiable intangible assets (such as internally generated brand names, patents or customer relationships), that the acquiree did not recognise. As the acquiring company is giving valuable consideration for these assets, they are now recognised as assets in the consolidated financial statements.

13.4.1 RESTRUCTURING AND FUTURE LOSSES

An acquirer **should not recognise liabilities for future losses** or other costs expected to be incurred as a result of the business combination.

IFRS 3 explains that a plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore, an acquirer **should not recognise a liability for** such **a restructuring plan** as part of allocating the cost of the combination unless the subsidiary was already committed to the plan before the acquisition.

This **prevents creative accounting**. An acquirer cannot set up a provision for restructuring or future losses of a subsidiary and then release this to profit or loss in subsequent periods in order to reduce losses or smooth profits.

Question 9: Goodwill on consolidation with fair value adjustments

On 1 September 20X7 Tyzo Co. acquired 6 million of the 8 million shares in Kono Co. at $2.00 per share. At that date Kono Co. produced the following interim financial statements.

	$m		$m
Property, plant and equipment (note 1)	16.0	Trade payables	3.2
Inventories (note 2)	4.0	Taxation	0.6
Receivables	2.9	Bank overdraft	3.9
Cash in hand	1.2	Long-term loans	4.0
		Share capital	8.0
		Retained earnings	4.4
	24.1		24.1

Notes

1. The property, plant and equipment of Kono Co. had a combined market value of $16.6 million at 1 September 20X7.
2. The inventories of Kono Co. which were shown in the interim financial statements are raw materials. They would have cost $4.2 million to replace at 1 September 20X7.
3. On 1 September 20X7 Tyzo Co. took a decision to rationalise the group so as to integrate Kono Co. The costs of the rationalisation were estimated to total $3.0 million and the process was due to start on 1 March 20X8. No provision for these costs has been made in the financial statements given above.
4. Tyzo Group values the non-controlling interest using the proportion of net assets method.

Required

Compute the goodwill on consolidation of Kono Co. that will be included in the consolidated financial statements of the Tyzo Co. group for the year ended 31 December 20X7, explaining your treatment of the items mentioned above. You should refer to the provisions of relevant accounting standards.

(The answer is at the end of the module.)

KEY MODULE POINTS 2

- Where the parent does not hold 100 per cent of the shares in the subsidiary, the non-controlling interest must be represented.
- IFRS 3 allows two alternative ways of measuring the non-controlling interest at acquisition:
  - as a proportionate share of the fair value of the subsidiary's net assets; **or**
  - at full (or fair) value (usually based on the market value of the shares held by the non-controlling interest).
- The non-controlling interest reported in the consolidated statement of financial position at subsequent reporting dates is increased by the non-controlling interest's share of profits made by the subsidiary since acquisition.
- Goodwill arises where the consideration transferred by the parent is not equal to the group share of net assets at acquisition.
- Goodwill is calculated as consideration plus NCI less the fair value of the net assets of the subsidiary at acquisition.
- Fair value adjustments may therefore be required to the subsidiary's accounts before consolidation.
- Goodwill arising on consolidation is not amortised but is subjected to an annual impairment review and any loss is debited to group reserves.
- A bargain purchase is reassessed and then credited to profit or loss immediately.
- IFRS 10 sets out the procedures to prepare a consolidated statement of financial position.
- The basic procedure involves:
  - adding the assets and liabilities of the parent and subsidiary on a line by line basis
  - cancelling any intercompany amounts
  - eliminating the parent's investment in the subsidiary and replacing it with the subsidiary's net assets
  - including the share capital of the parent only
  - calculating group reserves as the parent's reserves plus the group share of post-acquisition reserves of the subsidiary
- Unrealised profits made on the sale of goods or non-current assets to group companies must be eliminated on consolidation.

QUICK REVISION QUESTIONS 2

1 Major Co, which makes up its accounts to 31 December, has an 80 per cent owned subsidiary Minor Co. Minor Co. sells goods to Major Co. at a mark-up on cost of 33.3 per cent. At 31 December 20X8, Major had $12 000 of such goods in its inventory and at 31 December 20X9 had $15 000 of such goods in its inventory.

What is the amount by which the consolidated profit attributable to Major Co.'s shareholders should be adjusted in respect of the above?

Ignore taxation.

A $600 debit
B $750 credit
C $800 credit
D $1000 debit

The following information is relevant for questions 2 to 4

On 1 January 20X0 Alpha purchased 80 000 of the 100 000 ordinary shares in Beta for $180 000. At that date Beta's retained earnings amounted to $90 000 and the fair values of Beta's assets at acquisition were equal to their book values.

Three years later, on 31 December 20X2, the statements of financial position of the two companies were:

	Alpha	Beta
	$	$
Sundry net assets	230 000	260 000
Shares in Beta	180 000	–
	410 000	260 000
Share capital		
Ordinary shares	200 000	100 000
Retained earnings	210 000	160 000
	410 000	260 000

The share capital of Beta has remained unchanged since 1 January 20X0. The non-controlling interest is measured at full fair value and goodwill attributable to the non-controlling interest at acquisition was $4000. There was no impairment of goodwill.

2 What amount should appear in the group's consolidated statement of financial position at 31 December 20X2 for goodwill?

A $14 000
B $25 000
C $28 000
D $32 000

3 What amount should appear in the group's consolidated statement of financial position at 31 December 20X2 for non-controlling interest?

A $32 000
B $48 000
C $52 000
D $56 000

4 What amount should appear in the group's consolidated statement of financial position at 31 December 20X2 for retained earnings?

A $245 000
B $266 000
C $338 000
D $370 000

5 Strachey owns 75 per cent of the share capital in Bell. At 31 July 20X2, the inventory of Strachey was valued at $420 000 and included goods costing $60 000 that it had purchased from Bell at cost plus 20 per cent.

At 31 July 20X2, inventories were valued at $445 000 in the consolidated statement of financial position of the Strachey group.

At 31 July 20X2, what is the inventory figure in the statement of financial position of Bell?

A $13 000
B $15 000
C $35 000
D $37 000

6 The summarised statements of financial position of Falcon and Kestrel at 31 December 20X8 were as follows:

	Falcon $m	Kestrel $m
Net assets (at fair values)	68	25
Share capital	10	10
Reserves	58	15
	68	25

On 1 January 20X8 Falcon purchased 80 per cent of the equity share capital of Kestrel for $24 million. The fair value of the net assets of Kestrel was $20 million at that date. The goodwill arising on consolidation was impaired by 100 per cent. Non controlling interests are measured at the proportionate share of net assets acquired.

Calculate the amount of consolidated reserves to be included in the statement of financial position at 31 December 20X8.

A $54m
B $62m
C $65m
D $70m

7 Harrow acquired 270 000 ordinary shares in Slough on 1 January 20X9 at a cost of $400 000. At that date, Slough had 300 000 ordinary $1 shares in issue and its reserves were $50 000. Non-controlling interests are measured at the proportionate share of the net assets acquired.

The amount of goodwill arising on consolidation is:

A $50 000
B $80 000
C $85 000
D $130 000

8 STV owns 75 per cent of the ordinary share capital of its subsidiary TUW. At the group's year end, 28 February 20X7, STV's payables include $3600 in respect of inventories sold to it by TUW.

TUW's receivables include $6700 in respect of inventories sold to STV. Two days before the year end STV sent a payment of $3100 to TUW that was not recorded by the latter until two days after the year end.

The in-transit item should be dealt with as follows in the consolidated statement of financial position at 28 February 20X7:

A $2325 to be included as cash in transit
B $3100 to be included as cash in transit
C $3100 to be included as inventories in transit
D $3100 to be added to consolidated payables

9 Ploughshare acquired 80 per cent of the equity share capital of Sword on 30 September 20X1. On 31 December 20X1, the share capital and reserves of Sword were:

	$'000
Ordinary shares	300
Retained earnings at 1 January 20X1	80
Retained profit for the year ended 31 December 20X1	40
	420

The profits of Sword have accrued evenly throughout 20X1. Goodwill arising on the acquisition was $20 000. Non-controlling interests are measured at the proportionate share of the net assets acquired.

What was the cost of the investment in Sword?

A $324 000
B $332 000
C $348 000
D $356 000

10 XY owns 75 per cent of the issued equity share capital of PQ. At the year end, XY held inventories valued at $160 000 and PQ held inventories valued at $90 000. The inventories held by XY included $20 000 of goods purchased from PQ at a profit margin of 30 per cent. There was also inventories in transit between the two companies; this amounted to a further $10 000 at selling price.

At what value should inventories appear in the consolidated statement of financial position?

A $228 500
B $251 000
C $254 000
D $266 000

14 BASIC PRINCIPLES OF THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS

LO 5.5

Section overview

- The consolidated statement of profit or loss is produced by aggregating amounts from the individual accounts of the parent and subsidiary. The **non-controlling interest (NCI)** is recognised as a one-line adjustment at the end of the statement.

The consolidated statement of profit or loss is based on the following principles:

- Income and expenses of the parent and subsidiary are added together on a line by line basis.
- Dividend income in the parent's statement of profit or loss from the subsidiary is cancelled.
- The profit shown in the statement of profit or loss must be attributed to the non-controlling interest and the parent in proportion to their ownership share.
- The non-controlling interest in profit is calculated as the NCI's share of the profit of the subsidiary for the year after any consolidation adjustments attributable to the subsidiary.

Worked Example: Consolidated statement of profit or loss

P Co. acquired 75 per cent of the ordinary shares of S Co. on that company's incorporation in 20X3.

The summarised statements of profit or loss and movement on retained earnings of the two companies for the year ending 31 December 20X6 are set out below:

	P Co.	S Co.
	$	$
Revenue	75 000	38 000
Cost of sales	30 000	20 000
Gross profit	45 000	18 000
Administrative expenses	14 000	8 000
Profit before tax	31 000	10 000
Income tax expense	10 000	2 000
Profit for the year	21 000	8 000

Note: Movement in retained earnings

Retained earnings brought forward	87 000	17 000
Profit for the year	21 000	8 000
Retained earnings carried forward	108 000	25 000

Required

Prepare the consolidated statement of profit or loss and extract from the statement of changes in equity showing retained earnings and non-controlling interest for the year.

Solution

P CO.
CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X6

	$
Revenue (75 + 38)	113 000
Cost of sales (30 + 20)	50 000
Gross profit	63 000
Administrative expenses (14 + 8)	22 000
Profit before tax	41 000
Income tax expense (10 + 2)	12 000
Profit for the year	29 000

	$
Profit attributable to:	
Parent	27 000
Non-controlling interest ($8000 × 25%)	2 000
	29 000

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	Retained earnings $	Non-controlling interest $
Balance at 1 January 20X6		
(**RE**)((87 000 + (17 000 × 75%))(**NCI**) (17 000 × 25%)	99 750	4 250
Total comprehensive income for the year	27 000	2 000
Balance at 31 December 20X6	126 750	6 250

Notice how the non-controlling interest is dealt with:

- Down to the line '**profit for the year**' the **whole** of S Co.'s results is included without reference to group share or non-controlling share. The profit is then allocated between the NCI and the parent.
- Retained earnings at 1 January 20X6 is calculated on the same basis as that used in the statement of financial position detailed earlier in this module: the group share of S Co.'s retained earnings brought forward of $12 750 (75% × $17 000) are added to P Co.'s retained earnings brought forward of $87 000.
- The non-controlling interest brought forward of $4250 is calculated as the NCI share of S Co.'s retained earnings brought forward (17 000 × 25%).
- The group retained earnings figure of $126 750 should be the same as the amount reported in the consolidated statement of financial position.

We now consider the complications introduced by **inter-company trading**, **inter-company dividends** and **pre-acquisition profits** in the subsidiary.

15 INTRA-GROUP TRANSACTIONS

LO 5.5

Section overview

- Intra-group sales and purchases are eliminated from the consolidated statement of profit or loss.

15.1 INTRA-GROUP TRADING

Like the consolidated statement of financial position, the consolidated statement of profit or loss deals with the results of the group as those of a single entity. When one company in a group sells goods to another an identical amount is added to the sales revenue of the first company and to the cost of sales of the second. Yet as far as the group's dealings with outsiders are concerned no sale has taken place.

The consolidated figures for sales revenue and cost of sales should represent **sales to**, and **purchases from, outsiders**. So, reduce sales revenue and cost of sales by the sales value of intra-group sales during the year.

Also, we need to remove unrealised profits on intra-group trading. So, **calculate the unrealised profit on unsold inventories at the year end and increase the cost of sales of the seller by this amount**.

Worked Example: Intra-group trading

Suppose in our earlier example that S Co. had recorded sales of $5000 to P Co. during 20X6. S Co. had purchased these goods from outside suppliers at a cost of $3000. One half of the goods remained in P Co.'s inventory at 31 December 20X6. Prepare the revised consolidated statement of profit or loss.

Solution

The consolidated statement of profit or loss for the year ended 31 December 20X6 would now be as follows:

	$
Revenue (75 + 38 – 5)	108 000
Cost of sales (30 + 20 – 5 + 1*)	(46 000)
Gross profit	62 000
Administrative expenses	(22 000)
Profit before taxation	40 000
Income tax expense	(12 000)
Profit for the year	28 000
Profit attributable to:	
Parent	26 250
Non-controlling interest (8000 – 1000) × 25%	1 750
	28 000

Note:

Retained earnings brought forward	99 750
Profit for the year	26 250
Retained earnings carried forward	126 000

*Unrealised profit: ½ × ($5000 – $3000)

An adjustment will be made for the unrealised profit against the inventory figure in the consolidated statement of financial position.

15.2 INTRA-GROUP TRANSFERS OF NON-CURRENT ASSETS

Earlier we saw that intra-group transfers of non-current assets are also likely to result in an unrealised profit. The consolidated financial statements must show non-current assets at their depreciated cost to the group and therefore such unrealised profits are eliminated on consolidation.

The adjustment required to the statement of profit or loss depends upon whether the non-current asset was transferred in the current or a previous year.

Where the transfer was in a previous year, adjustment is made to ensure that the depreciation charge is based on the cost of the asset to the group.

Where the transfer was made in the year, the depreciation charge must be adjusted and any profit or loss on disposal recorded in the profit of the selling company must be removed.

Adjustments are made in the selling company's statement of profit or loss in the cost category in which depreciation is charged.

Question 10: Transfer of non-current assets

Way Co. transferred a machine to Sly Co. on 1 May 20X8 for $26 000. The original cost of the machine on 1 May 20X4 was $40 000, and on this date the asset was estimated to have a 10 year useful life. After the transfer, Sly Co. continues to depreciate the machine over its remaining useful life.

What adjustment must be made to consolidated cost of sales in the year ended 31 December 20X8?

(The answer is at the end of the module.)

15.3 INTRA-GROUP DIVIDENDS

A subsidiary may distribute some of its profits as dividends. The dividend received by the parent is recorded in the parent's own accounts as income. On consolidation this must be removed as it is not income from outside the group.

16 PRE-ACQUISITION PROFITS AND MID-YEAR ACQUISITIONS

Section overview

- Only the **post-acquisition** profits of the subsidiary are included in consolidated profit or loss.

Retained earnings in the consolidated statement of financial position comprise:

- the **whole of the parent's** retained earnings; and
- the **group's share of post-acquisition retained earnings** in the subsidiary.

So, the results of a subsidiary are consolidated only from the date of acquisition.

If a subsidiary is **acquired during the accounting year**, the entire statement of profit or loss of the subsidiary is split into pre-acquisition and post-acquisition proportions. Only the post-acquisition figures are included in the consolidated statement of profit or loss.

Question 11: Acquisition

P Co. acquired 60 per cent of the $100 000 equity of S Co. on 1 April 20X5. The statements of profit or loss of the two companies for the year ended 31 December 20X5 are set out below:

	P Co.	S Co.	S Co. (9/12)
	$	$	$
Revenue	170 000	80 000	60 000
Cost of sales	65 000	36 000	27 000
Gross profit	105 000	44 000	33 000
Other income – dividend received S Co	3 600		
Administrative expenses	43 000	12 000	9 000
Profit before tax	65 600	32 000	24 000
Income tax expense	23 000	8 000	6 000
Profit for the year	42 600	24 000	18 000

Note:

	P Co.	S Co.
	$	$
Dividends (paid 31 December)	12 000	6 000
Profit retained	30 600	18 000
Retained earnings brought forward	81 000	40 000
Retained earnings carried forward	111 600	58 000

Prepare the consolidated statement of profit or loss and the retained earnings and non-controlling interest extracts from the statement of changes in equity.

(The answer is at the end of the module.)

Question 12: Non-controlling interest

The following information relates to Brodick Co. and its subsidiary Lamlash Co. for the year to 30 April 20X7.

	Brodick Co. $'000	Lamlash Co. $'000
Revenue	1 100	500
Cost of sales	(630)	(300)
Gross profit	470	200
Administrative expenses	(105)	(150)
Dividend from Lamlash Co.	24	–
Profit before tax	389	50
Income tax expense	(65)	(10)
Profit for the year	324	40
Note:		
Dividends paid	200	30
Profit retained	124	10
Retained earnings brought forward	460	106
Retained earnings carried forward	584	116

Additional information

(a) The issued share capital of the group is as follows.
Brodick Co.: 5 000 000 ordinary shares totalling $5m
Lamlash Co.: 1 000 000 ordinary shares totalling $1m

(b) Brodick Co. purchased 80 per cent of the issued share capital of Lamlash Co. in 20X0. At that time, the retained earnings of Lamlash stood at $56 000.

Required

To the extent that the information permits, prepare the Brodick group consolidated statement of profit or loss for the year to 30 April 20X7, and extracts from the consolidated statement of changes in equity showing retained earnings and non-controlling interest.

(The answer is at the end of the module.)

17 OTHER ADJUSTMENTS

LOs 5.2, 5.5

Section overview

- Adjustments must be made where a depreciable asset in the subsidiary's accounts has been the subject of a fair value uplift or where goodwill has been impaired.

17.1 FAIR VALUE ADJUSTMENTS

When dealing with the consolidated statement of financial position, we discussed the adjusting of assets (and liabilities) in the subsidiary's accounts to reflect fair value at the date of acquisition.

If a non-current asset is the subject of a fair value uplift for consolidation purposes we need to charge extra depreciation. Depreciation based on the book value of the asset will be included in the subsidiary's own statement of profit or loss, the depreciation charge on the revalued amount will be bigger and the difference is a consolidation adjustment.

17.2 GOODWILL IMPAIRMENT

If goodwill has been impaired in the period, the impairment loss must be charged to consolidated profits. Usually this amount is included in administrative expenses in the consolidated statement of profit or loss.

Where the non-controlling interest is measured at fair value, part of the impairment is allocated to non-controlling interest goodwill. The proportion relating to the non-controlling interest is deducted from the profits allocated to the NCI.

Where the non-controlling interest is measured as a proportion of the net assets of the subsidiary, goodwill relates only to the parent and therefore no adjustment to the non-controlling interest in profit is required.

18 SUMMARY: CONSOLIDATED STATEMENT OF PROFIT OR LOSS

The table below summarises the main points about the consolidated statement of profit or loss.

PURPOSE	To show the results of the group for an accounting period as if it were a single entity.
REVENUE TO PROFIT FOR YEAR	100 per cent P + 100 per cent S (excluding adjustments for inter-company transactions).
REASON	To show the results of the group which were controlled by the parent.
INTRA-GROUP SALES	Remove selling price from both revenue and cost of sales.
UNREALISED PROFIT ON INTRA-GROUP SALES	(a) Goods sold by P. Increase cost of sales by unrealised profit. (b) Goods sold by S. Increase cost of sales by unrealised profit and decrease non-controlling interest by their share of unrealised profit.
DEPRECIATION	If the value of S's non-current assets has been subjected to a fair value uplift, additional depreciation must be charged in the consolidated statement of profit or loss. The non-controlling interest will need to be adjusted for their share.
TRANSFER OF NON-CURRENT ASSETS	Expenses must be adjusted for any profit on the transfer and for any additional depreciation arising from the increased carrying amount of the asset.
NON-CONTROLLING INTERESTS	S's profit after tax (PAT) X Less: * unrealised profit (X) * profit on disposal of non-current assets (X) additional depreciation following FV uplift (X) Add: ** additional depreciation following disposal of non-current assets X X NCI% X * Only applicable if sales of goods and non-current assets made by subsidiary. ** Only applicable if sale of non-current assets made by subsidiary.
REASON	To show the extent to which profits generated through P's control are in fact owned by other parties.

KEY MODULE POINTS 3

- The consolidated statement of profit or loss is produced by adding amounts in the individual accounts of the parent and subsidiary on a line by line basis.
- The non-controlling interest is a one-line adjustment at the end of the statement. It is calculated as the NCI share of the profits of the subsidiary for the year, after any consolidation adjustments attributable to the subsidiary.
- Intra-group sales and purchases are eliminated from the consolidated statement of profit or loss.
- Any unrealised profits are eliminated.
- Intra-group dividends are eliminated.
- Only the post-acquisition profits of the subsidiary are included in the consolidated statement of profit or loss. The profits of the subsidiary must be pro-rated if acquired mid-year.
- Where a non-current asset is the subject of a fair value uplift for consolidation purposes extra depreciation is added as a consolidation adjustment.
- Where goodwill has been impaired in the period, the impairment loss is charged to the consolidated statement of profit or loss.

QUICK REVISION QUESTIONS 3

1 At the beginning of the year a 75 per cent subsidiary transfers a non-current asset to the parent for $500 000. At that date, its carrying amount was $400 000 and it had four years of useful life left. What adjustment is made to total consolidated profit before tax for the year in respect of the transfer?

A $25 000 credit
B $75 000 debit
C $100 000 credit
D $100 000 debit

2 AB acquired a 60 per cent holding in CD many years ago. At 31 December 20X3 AB held inventory with a book value of $30 000 purchased from CD at cost plus 20 per cent.

The effect on the consolidated statement of profit or loss for the year is:

	Profit attributable to parent	Profit attributable to non-controlling interest
A	reduced by $5000	no effect
B	reduced by $6000	no effect
C	reduced by $3000	reduced by $2000
D	reduced by $3600	reduced by $2400

The following information is relevant for questions 3 and 4

Hardy has a 90 per cent subsidiary, Lawrence. During the year ended 31 December 20X2 Lawrence sold goods to Hardy for $25 000, which was cost plus 25 per cent. At 31 December 20X2 $10 000 of these goods remained unsold.

3 In the consolidated statement of profit or loss for the year ended 31 December 20X2, revenue will be reduced by

A $18 750
B $20 000
C $22 500
D $25 000

4 In the consolidated statement of profit or loss for the year ended 31 December 20X2, gross profit will be reduced by

A $1800
B $2000
C $2250
D $2500

5 Parent owned 80 per cent of the issued equity share capital of Subsidiary. For the year ended 31 December 20X6 Subsidiary reported a profit before tax of $55 million. During 20X6 Subsidiary sold goods to Parent for $15 million at cost plus 20 per cent. At the year end half these goods are still held by Parent.

In the consolidated statement of profit or loss for the year ended 31 December 20X6 the non-controlling interest is

A $8 million.
B $10.7 million.
C $10.75 million.
D $11 million.

6 Where the purchase price of an acquisition is less than the aggregate fair value of the net assets acquired, which *one* of the following accounting treatments of the difference is required by IFRS 3 *Business Combinations*?

A immediate recognition as a gain in profit or loss
B recognition in profit over its estimated useful life
C immediate recognition as a gain in the statement of changes in equity
D deduction from goodwill in the consolidated statement of financial position

7 GPT regularly sells goods to its subsidiary in which it owns 60 per cent of the ordinary share capital. During the group's financial year ended 31 August 20X7, GPT sold goods to its subsidiary valued at $100 000 (selling price) upon which it makes a margin of 20 per cent. By the group's year end all of the goods had been sold to parties outside the group.

What is the correct consolidation adjustment in respect of these sales for the year ended 31 August 20X7?

A no adjustment required
B *Dr.* Revenue $60 000; *Cr.* Cost of sales $60 000
C *Dr.* Revenue $80 000; *Cr.* Cost of sales $80 000
D *Dr.* Revenue $100 000; *Cr.* Cost of sales $100 000

8 Lay Co. acquired 90 per cent of the ordinary shares in Hay Co. on 1 August 20X8 at a cost of $450 000. On that date the net assets of Hay Co. amounted to $460 000. In the year ended 30 June 20X9, Lay Co. reported a profit of $189 000 and Hay Co. of $60 000. Trading conditions indicated that the goodwill in Hay Co. may be impaired and a review found that it was indeed impaired by 50 per cent. It is Lay Co. group policy to measure the non-controlling interest as a percentage of net assets. What is the profit for the year ended 30 June 20X9 before allocation to the group owners and the non-controlling interest?

A $208 000
B $213 000
C $226 000
D $231 000

9 Radio Co. acquired 85 per cent of the ordinary shares in Stereo Co. a number of years ago giving rise to $14 000 of goodwill calculated using the full fair value method. The following is relevant to the year ended 31 December 20X8:

– Radio Co. has reported a profit of $90 000.
– Stereo Co. has reported a profit of $40 000.
– Intercompany sales were made by Radio to Stereo amounting to $20 000 at cost plus 10 per cent. Half of the goods remain in inventory at the year end.
– Goodwill is impaired by $6000.

What is the non-controlling interest in profit for the year?

A $4191
B $5091
C $5100
D $6000

19 ACCOUNTING FOR ASSOCIATES

Section overview

- Accounting for associates is covered by IAS 28 *Investments in Associates and Joint Ventures*. The investing company does not have control, as it does with a subsidiary, but it does have **significant influence**.

Definitions

Associate. An entity over which the investor has significant influence.

Significant influence. The power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

Equity method. A method of accounting where the investment is initially recognised at cost and then adjusted for the post-acquisition change in the investor's share of the investee's net assets and the investor's share of the investee's profit or loss is recognised in group profit.

19.1 IAS 28

IAS 28 requires all investments in associates to be accounted for in the consolidated accounts using the equity method, **unless** the investment is classified as 'held for sale' in accordance with IFRS 5 (not within the FAR syllabus), or the exemption in the paragraph below applies.

An investor is exempt from applying the equity method if:

- It is a parent exempt from preparing consolidated financial statements under IFRS 10; or
- **All** of the following apply:
  - The investor is a **wholly-owned subsidiary** or it is a **partially-owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;
  - The investor's securities are **not publicly traded**;
  - It is **not in the process of issuing securities** in public securities markets; and
  - The **ultimate or intermediate parent** publishes consolidated financial statements that comply with IFRS.

The use of the equity method is **discontinued** from the date that the investor **ceases to be an associate**. From that date:

- If the investment becomes a subsidiary, it should be consolidated in accordance with IFRS 3 and IFRS 10.
- If the retained interest is a financial asset (simple investment) the investor should account for the investment in accordance with IFRS 9. The carrying amount of the investment at the date that it ceases to be an associate should be regarded as its fair value on initial measurement as a financial asset under IFRS 9. Note that IFRS 9 is not within the scope of the FAR syllabus.

19.2 SEPARATE FINANCIAL STATEMENTS OF THE INVESTOR

An investment in an associate is recorded in the investor's separate financial statements **either**:

- at **cost**; or
- at fair value (in accordance with **IFRS 9**).

This applies regardless of whether consolidated financial statements are produced or not.

20 THE EQUITY METHOD

Section overview

- The group share of the associate's profit after tax forms part of group profits in the consolidated statement of profit or loss; the associate is recognised in the consolidated statement of financial position at cost plus the group share of the associate's post-acquisition retained profits.

20.1 APPLICATION OF THE EQUITY METHOD: CONSOLIDATED FINANCIAL STATEMENTS

Associates are not consolidated on a line by line basis because unlike subsidiaries, they and their assets and liabilities are not controlled by the parent. The existence of significant influence means that the parent's share of an associate's net assets and profits should be recognised in the consolidated accounts. This is achieved by equity accounting.

Many of the adjustments required by the equity method are the same as are required for full consolidation. In particular, **intra-group unrealised profits** must be excluded.

20.1.1 CONSOLIDATED STATEMENT OF PROFIT OR LOSS

The basic principle is that the investing company (P Co.) should take account of its **share of the earnings** of the associate, A Co., whether or not A Co. distributes the earnings as dividends. P Co. achieves this by adding the group's share of A Co.'s profit after tax to consolidated profit.

Notice the difference between this treatment and the **consolidation** of a subsidiary's results. If A Co. was a subsidiary P Co. would take credit for the whole of its sales revenue, cost of sales etc. and would then make a one-line adjustment to remove any non-controlling share. Under equity accounting, the associate's sales revenue, cost of sales and so on are ***not* amalgamated** with those of the group just the group share of the associate's profit after tax for the year is added to the group profit.

20.1.2 CONSOLIDATED STATEMENT OF FINANCIAL POSITION

A figure for **investment in associates** is shown in non current assets. At acquisition it is stated at cost, and is recorded by:

Dr. Investment in associate

Cr. Cash/consideration

This amount will increase (decrease) each year by the amount of the group's share of the associate's profit (loss) for the year.

Worked Example: Associate

P Co., a company with subsidiaries, acquires 25 000 of the 100 000 ordinary shares in A Co. for $60 000 on 1 January 20X8. In the year to 31 December 20X8, A Co. earns profits after tax of $24 000, from which it pays a dividend of $6000.

How will A Co.'s results be accounted for in the individual and consolidated accounts of P Co. for the year ended 31 December 20X8?

Solution

In the **individual accounts** of P Co., the investment will be recorded on 1 January 20X8 at cost. Unless there is an impairment in the value of the investment (see below), this amount will remain in the individual statement of financial position of P Co. permanently. The only entry in P Co.'s individual statement of profit or loss will be to record dividends received. For the year ended 31 December 20X8, P Co. will:

Dr.	Cash	$1500	
Cr.	Income from shares in associates		$1500

In the **consolidated accounts** of P Co. equity accounting principles will be used to account for the investment in A Co. Consolidated profit after tax will include the group's share of A Co.'s profit after tax (25% × $24 000 = $6000). To the extent that this has been distributed as dividend, it is already included in P Co.'s individual accounts and will automatically be brought into the consolidated results. That part of the group's share of profit in the associate which has not been distributed as dividend ($4500) will be brought into consolidation by the following adjustment.

Dr.	Income from shares in associates	$1500	
Dr.	Investment in associates	$4500	
Cr.	Share of profit of associates		$6000

The asset 'Investment in associates' is then stated at $64 500, being cost plus the group share of post-acquisition retained profits.

21 CONSOLIDATED STATEMENT OF PROFIT OR LOSS

LO 5.5

Section overview

- In the **consolidated statement of profit or loss** the investing group includes its **share of the after-tax profits** of associates whether or not they are distributed as dividends.

A **consolidation schedule** may be used to prepare the consolidated statement of profit or loss of a group with associates. The treatment of associates' profits in the following example should be studied carefully.

21.1 EXAMPLE: CONSOLIDATION SCHEDULE

The following **consolidation schedule** relates to the P Co. group, consisting of the parent, an 80 per cent owned subsidiary (S Co.) and an associate (A Co.) in which the group has a 30 per cent interest.

CONSOLIDATION SCHEDULE

	Group	P Co.	S Co.	A Co.
	$'000	**$'000**	**$'000**	**$'000**
Revenue	1 400	600	800	300
Cost of sales	770	370	400	120
Gross profit	630	230	400	180
Administrative expenses	290	110	180	80
	340	120	220	100
Interest receivable	30	30	–	–
	370	150	220	100
Interest payable	(20)	–	(20)	–
Share of profit of associate (57 × 30%)	17	–	–	
	367	150	200	100
Income tax expense				
Group	(145)	(55)	(90)	
Associate		–	–	(43)
Profit for the year	222	95	110	57
Non-controlling interest (110 × 20%)	(22)			
	200			

Notes

1. Group sales revenue, group gross profit and costs such as depreciation and so on exclude the sales revenue, gross profit and costs of associated companies.
2. The group share of the associate's profits is credited to the group statement of profit or loss. If the associate has been acquired during the year, deduct the pre-acquisition profits.
3. The non-controlling interest only applies to subsidiary companies.

21.2 PRO-FORMA STATEMENT OF PROFIT OR LOSS

The following is a **suggested layout** (using the figures given in the example above) for the consolidated statement of profit or loss for a company having subsidiaries as well as associates.

	$'000
Revenue	1 400
Cost of sales	(770)
Gross profit	630
Other income: interest receivable	30
Administrative expenses	(290)
Finance costs	(20)
Share of profit of associate	17
Profit before tax	367
Income tax expense	(145)
Profit for the year	222
Profit attributable to:	
Parent	200
Non-controlling interest	22
	222

22 CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Section overview

- In the consolidated statement of financial position the investment in associates is recognised at an amount of:
  - cost of the investment in the associate; plus
  - group share of post acquisition profits; less
  - amounts paid as dividends **by the associate to the parent**; less
  - impairments.

As explained earlier, the consolidated statement of financial position will contain a non-current **asset 'Investment in associates'** which is the original cost plus the group's share of any **profits earned since acquisition** which have not been distributed as dividends less any impairment loss (see section 22.3).

Worked Example: Consolidated statement of financial position

On 1 January 20X6 the net assets of A Co. were $220 000, financed by $100 000 ordinary shares and retained earnings of $120 000. P Co., a company with subsidiaries, acquires on 1 January 20X6 30 per cent of the shares in A Co. for $75 000. During the year ended 31 December 20X6 A Co.'s profit after tax is $30 000, from which dividends of $12 000 are paid.

Show how P Co.'s investment in A Co. would appear in the consolidated statement of financial position at 31 December 20X6.

Solution

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X6 (extract)

	$
Non-current assets	
Investment in associate	
Cost	75 000
Group share of post-acquisition retained profits (30% × $18 000)	5 400
	80 400

Question 13: Associate

Set out below are the draft accounts of Parent Co. and its subsidiaries and of Associate Co. Parent Co. acquired 40 per cent of the equity capital of Associate Co. three years ago when the latter's reserves stood at $40 000.

SUMMARISED STATEMENTS OF FINANCIAL POSITION

	Parent Co. and subsidiaries $'000	Associate Co. $'000
Tangible non-current assets	220	170
Investment in Associate Co. at cost	60	–
Loan to Associate Co.	20	–
Current assets	100	50
Loan from Parent Co.	–	(20)
	400	200
Share capital	250	100
Retained earnings	150	100
	400	200

SUMMARISED STATEMENTS OF PROFIT OR LOSS

	Parent Co. and subsidiaries $'000	Associate Co. $'000
Profit before tax	95	80
Income tax expense	35	30
Profit before tax for the year	60	50

You are required to prepare the summarised consolidated financial statements of Parent Co.

Notes

1. Assume that the associate's assets/liabilities are stated at fair value.
2. Assume that there are no non-controlling interests in the subsidiary companies.
3. Assume that the loan from Parent Co. to Associate Co. is long-term so is part of Parent's investment in Associate

(The answer is at the end of the module.)

Question 14: Associate

Alfred Co. bought a 25 per cent shareholding on 31 December 20X8 in Grimbald Co. at a cost of $38 000.

During the year to 31 December 20X9 Grimbald Co. made a profit before tax of $82 000 and the taxation charge on the year's profits was $32 000. A dividend of $20 000 was paid on 31 December out of these profits.

Calculate the entries for the associate which would appear in the consolidated accounts of the Alfred group, in accordance with the requirements of IAS 28.

(The answer is at the end of the module.)

The following points are also relevant and are similar to a parent-subsidiary consolidation situation:

- Use financial statements drawn up to the **same reporting date**.
- If this is impracticable, adjust the financial statements for **significant transactions/events** in the intervening period. The difference between the reporting date of the associate and that of the investor must be no more than three months.
- Use **uniform accounting policies** for like transactions and events in similar circumstances, adjusting the associate's statements to reflect group policies if necessary.

23 ADJUSTMENTS

23.1 TRANSACTIONS BETWEEN AN INVESTOR AND AN ASSOCIATE

Profits and losses resulting from transactions between an investor (including consolidated subsidiaries) and an associate are eliminated to the extent of the investor's interest in the associate. This is very similar to the procedure for eliminating intra-group transactions between a parent and a subsidiary. The important thing to remember is that **only the group's share is eliminated**. The principle is the same, whether the parent is selling to the associate, or the associate is selling to the parent.

Worked Example: P sells to A

P Co., a parent with subsidiaries, holds 25 per cent of the share capital in A Co. During the year, P Co. makes sales of $1 000 000 to A Co. at cost plus a 25 per cent mark-up. At the year-end, A Co. has all these goods still in inventories.

Solution

P Co. has recorded a profit of $200 000 (1 000 000 × 25 / 125) on its sales to the associate. The group's share (25 per cent) of this must be eliminated:

Dr.	Share of profit of associates		
	(consolidated statement of profit or loss)	$50 000	
Cr.	Investment in associate (consolidated statement of financial position)		$50 000

(The same consolidation adjustment would be made if it had been A Co. which had sold the goods to P Co. during the year.)

23.2 ASSOCIATE'S LOSSES

When the equity method is used and the investor's share of losses of the associate equals or exceeds its investment in the associate, the investor should **stop** including its share of further losses. The investment is recognised at nil value. Once the value is reduced to nil, **additional losses** are only

recognised if the investor has incurred obligations or made payments on behalf of the associate (for example, if it has guaranteed amounts owed to third parties by the associate).

23.3 IMPAIRMENT LOSSES

An investment in an associate may become impaired. An impairment loss is recognised in accordance with IAS 36 *Impairment of Assets* for each associate individually.

The accumulated impairment loss is deducted from the carrying amount of the investment in the associate in the consolidated statement of financial position.

The working would be as follows:

	$
Cost of investment	X
Share of post-acquisition retained earnings	X
	X
Impairment loss	(X)
Investment in associate	X

The impairment loss arising in the year is charged against the group share of the associate's profits recognised in the consolidated statement of profit or loss.

Question 15: Consolidated statement of financial position

The statements of financial position of J Co. and its investee companies, P Co. and S Co., at 31 December 20X5 are shown below:

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	J Co. $'000	P Co. $'000	S Co. $'000
Non-current assets			
Freehold property	1 950	1 250	500
Plant and machinery	795	375	285
Investments	1 500	–	–
	4 245	1 625	785
Current assets			
Inventory	575	300	265
Trade receivables	330	290	370
Cash	50	120	20
	955	710	655
Total assets	5 200	2 335	1 440
Equity and liabilities			
Equity			
Share capital	2 000	1 000	750
Retained earnings	1 460	885	390
	3 460	1 885	1 140
Non-current liabilities			
12% loan stock	500	100	
Current liabilities			
Trade payables	680	350	300
Bank overdraft	560	–	–
	1 240	350	300
Total equity and liabilities	5 200	2 335	1 440

Additional information

(a) J Co. acquired 600 000 of the 1 000 000 ordinary shares in P Co. on 1 January 20X0 for $1 000 000 when the retained earnings of P Co. were $200 000.

(b) At the date of acquisition of P Co., the fair value of its freehold property was considered to be $400 000 greater than its value in P Co.'s statement of financial position. P Co. had acquired the property in January 20W0 and the buildings element (comprising 50 per cent of the total value) is depreciated on cost over 50 years.

(c) J Co. acquired 225 000 of the 750 000 ordinary shares in S Co. on 1 January 20X4 for $500 000 when the retained earnings of S Co. were $150 000.

(d) P Co. manufactures a component used by both J Co. and S Co. Transfers are made by P Co. at cost plus 25 per cent. J Co. held $100 000 inventory of these components at 31 December 20X5 and S Co. held $80 000 at the same date.

(e) The goodwill in P Co. is impaired and should be fully written off. An impairment loss of $92 000 is to be recognised on the investment in S Co.

(f) The non-controlling interest is valued at the proportionate share of net assets.

Required

Prepare, in a format suitable for inclusion in the annual report of the J Group, the consolidated statement of financial position at 31 December 20X5.

(The answer is at the end of the module.)

KEY MODULE POINTS 4

- Accounting for associates is covered by IAS 28 *Investments in Associates and Joint Ventures*.
- The parent company does not have control, as it does with a subsidiary, but it does have significant influence.
- In the consolidated statement of profit or loss the group includes its share of the after-tax profits of associates.
- In the consolidated statement of financial position the investment in associates is:
  - cost of the investment in the associate; plus
  - group share of post acquisition profits; less
  - amounts paid as dividends by the associate to the parent; less
  - impairments.
- The group share of unrealised profit made on transactions between group companies and the associate is eliminated.

QUICK REVISION QUESTIONS 4

1 Which of the following statements regarding group accounting is/are correct?

I. Only the group's share of the assets of a subsidiary is reflected in the consolidated statement of financial position.

II. An investment in an associate is initially reflected in the consolidated statement of financial position at its cost.

III. The value of share capital in a consolidated statement of financial position will include the share capital of both the investor and the investee.

A I only
B II only
C III only
D none of the statements

2 Consul owns the following equity shareholdings in other entities:

Admiral	25 per cent
Sultan	20 per cent
Warrior	30 per cent

Consul has a seat on the board of each entity.

Consul is the largest shareholding in Admiral (no other shareholdings are larger than 10 per cent).

Another entity owns 25 per cent of the share capital in Sultan and also has a seat on its board. No other individual or entity owns more than 5 per cent of the equity share capital of Sultan.

Another entity holds 70 per cent of Warrior's equity and has a seat on its board. This entity ignores Consul's opinions most of the time.

Which entities are associates of Consul?

A Admiral only
B Admiral and Sultan only
C Admiral and Warrior only
D Admiral, Sultan and Warrior

3 Outlook has one subsidiary. On 1 January 20X7 Outlook purchased 30 per cent of the share capital of View for $12 million. The summarised statement of financial position of View at 31 December 20X7 was as follows:

	$m
Net assets (at book value)	30
Share capital	10
Retained earnings at 1 January 20X7	15
Profit for the year ended 31 December 20X7	5
	30

At 1 January 20X7 the fair value of the net assets of View was $5 million greater than their book value. The difference relates to land which is still owned by View at 31 December 20X7.

Using the equity method, at what value is the investment in View shown in the consolidated statement of financial position of the Outlook group at 31 December 20X7?

A $9.0m
B $10.5m
C $12.0m
D $13.5m

4 Savoy owns 80 per cent of Spring and 30 per cent of White. Spring also owns 15 per cent of White. Extracts from the statements of comprehensive income for the year ended 31 December 20X7:

	Savoy $'000	Spring $'000	White $'000
Gross profit	700	550	500

What is group gross profit for the year ended 31 December 20X7?

A $1 250 000
B $1 365 000
C $1 460 000
D $1 475 000

5 The following statements refer to a situation where an investing company (K) seeks to exert control or influence over another company (L). Assume that K is required to prepare consolidated accounts because of other investments.

I. If K controls the operating and financial policies of L, then L cannot be an associate of K.
II. If K owns more than 20 per cent, but less than 50 per cent of the share capital in L, then L is bound to be an associate of K.
III. If L is an associate of K, then any amounts payable by L to K are not eliminated when preparing the consolidated statement of financial position of K.

Which of the statements are correct?

A I only
B I and II only
C I and III only
D II and III only

6 As well as a 90 per cent investment in T, S held 25 per cent of the shares of U, and exerts a significant influence over it. U sells goods to S. During the year ending 31 March 20X4, U sells goods to S for $100 000. The cost of the goods to U is $80 000. At the year end, S's inventories include $16 000 of goods purchased from U.

What adjustment is required in respect of unrealised profit in the consolidated statement of financial position?

A $Nil
B $800
C $1000
D $3200

7 GPX's financial statements included an investment in associate at $6 600 000 in its consolidated statement of financial position at 30 September 20X5. At 30 September 20X6, the investment in associate had increased to $6 750 000. GPX's pre-tax share of profit in the associate was $420 000, with a related tax charge of $180 000. The net amount of $240 000 was included in the consolidated statement of profit or loss for the year ended 30 September 20X6.

There were no impairments to the investment in associate, or acquisitions or disposals of shares during the financial year.

What dividend is paid to GPX by the associate in the year ended 30 September 20X6?

A $90 000
B $240 000
C $390 000
D $420 000

8 Tami Co. has investments in a number of subsidiary companies and on 1 August 20X8 acquired a 30 per cent interest in Tiny Co. The investment cost $400 000. In the year ended 31 March 20X9, Tiny Co. reported a profit after tax of $66 000. What amounts are reported in the group financial statements in respect of Tiny Co.?

	Statement of financial position	Statement of profit or loss
A	$400 000	$13 200
B	$400 000	$19 800
C	$413 200	$13 200
D	$419 800	$19 800

9 Dune Group bought a 20 per cent investment in Sand Co. a number of years ago for $420 000. Since acquisition Sand Co. has made $530 000 retained profits, $180 000 of which are made in the year ended 31 December 20X8. At this date, an impairment review was carried out on Sand Co. and Dune's investment was found to be impaired by 5 per cent.

What amount is reported as income from the associate in the consolidated statement of profit or loss?

A $9700
B $15 000
C $30 740
D $36 000

10 AB owns a controlling interest in another entity, CD, and exerts significant influence over EF, an entity in which it holds 30 per cent of the ordinary share capital.

During the financial year ended 30 April 20X5, EF sold goods to AB valued at $80 000. The cost of the goods to EF was $60 000. 25 per cent of the goods remained in AB's inventory at 30 April 20X5.

At the period end, AB held $90 000 inventory, CD held $38 000 and EF held $65 000.

What inventory figure is reported in the consolidated statement of financial position?

A $126 500
B $128 000
C $191 500
D $193 000

ANSWERS TO QUICK REVISION QUESTIONS 1

1 B Shareholding in Jamee $= \frac{400\ 000 \text{ shares}}{1\,000\ 000 \text{ shares}} = 40\%$

With such a shareholding and with one director on the board of Jamee it is likely that Harvert has significant influence over the operating and financial policies of Jamee (although not control).

Therefore, this investment would be treated as an associate in the consolidated financial statements of Harvert.

2 C A controls B and D as a result of holding the majority of the shares in each company, therefore they are subsidiaries. B has significant influence over C and therefore C is an associate of B. C is not controlled by A or B and is therefore not a subsidiary of either of these companies.

3 D The company is no longer controlled; the laws passed by the government transfer control to the state from the majority shareholder.

4 C Representation of the parent on the board of directors of the investee is evidence of significant influence rather than dominant influence or control.

5 B With a shareholding of 44 per cent it would not appear that Orius has control of Eerus but particularly with representation on the board of directors it does seem to exert significant influence. Therefore, Eerus would be treated as an associate using equity accounting.

6 C An associate is accounted for using the equity method. An associate relationship is presumed where the holding of ordinary voting shares is at least 20 per cent, so the answer is not A. A further indicator of an associate relationship is the provision of management personnel – not simply operational personnel, hence not B. Where the parent has the power to govern the financial policies of the investee by agreement, this is evidence of a parent-subsidiary relationship.

7 B A subsidiary need not prepare accounts to the same date as the parent company in order for them to be consolidated, however the subsidiary's reporting date should be within three months either side of the group reporting date.

8 B II is untrue because consolidated accounts are only required where there is at least one subsidiary, not where there is an associate only.

III is untrue, as equity accounting is only required where there is significant influence over the investee, presumed to be the case when 20 per cent of the voting shares are held.

ANSWERS TO QUICK REVISION QUESTIONS 2

1 A $(15\,000 - 12\,000) \times \frac{33.3}{133.3} \times 80\%$

2 D

	$	$
Consideration transferred		180 000
Net assets acquired		
Share capital	100 000	
Retained earnings	90 000	
	190 000	
Group share (190 000 × 80%)		(152 000)
Goodwill attributable to parent		28 000
Goodwill attributable to non-controlling interest		4 000
Goodwill in statement of financial position		32 000

3 D Non-controlling interest = 20% × $260 000 = $52 000 + goodwill of $4 000 = $56 000

4 B

	$
Alpha retained earnings	210 000
Beta – group share post-acquisition (160 000 – 90 000) × 80%	56 000
	266 000

5 C

	$'000
Consolidated statement of financial position	445
Strachey	(420)
	25
Add provision for unrealised profit (60 × 20/120)	10
	35

6 A

	$m
Falcon	58
Kestrel 80% × (25 – 20)	4
Less impairment of goodwill	(8)
	54
Goodwill:	
Consideration transferred	24
Net assets acquired (80% × 20)	(16)
	8

7 C

	$'000
Consideration transferred	400
Net assets acquired (90% × 350)	(315)
	85

8 B $3100 to be included as cash in transit. The payment sent by STV the parent company to its subsidiary TUW should be included as cash in transit on consolidation.

9 C

	$'000	$'000
Net assets acquired:		
Ordinary shares	300	
Retained earnings at 1 January 20X1	80	
Retained profit for the 9 months ended 30 September 20X1 (9/12 × 40) 4040)	30	
	410	
Group share (80%)		328
Add goodwill		20
		348

10 B

	$'000
XY	160
PQ	90
Inventory in transit	10
Provision for unrealised profit (20 + 10) × 30%	(9)
	251

ANSWERS TO QUICK REVISION QUESTIONS 3

1 B

	$
Unrealised profit	100 000
Additional depreciation (100 / 4)	(25 000)
Net charge to profit or loss	75 000

	Dr. $	*Cr.* $
Non-current asset		100 000
Additional depreciation	25 000	
Group profit (75%)	56 250	
Non-controlling interest (25%)	18 750	
	100 000	100 000

2 C The amount of unrealised profit is $5000 (30 000 × 20/120).
The subsidiary has sold to the parent, therefore the unrealised profit has arisen in the accounts of the subsidiary and must be allocated between the parent and the non-controlling interest.

3 D Revenue is reduced by the full amount of intra-group sales.

4 B Gross profit is reduced by the element of unrealised profit, which is 10 000 × 25 / 125.

5 C

	$'000
Profit before tax of subsidiary	55 000
Less provision for unrealised profit (15 000 × 20/120 × ½)	(1 250)
	53 750
NCI share (20%)	10 750

6 A 'Negative goodwill' (referred to as a bargain purchase in IFRS 3) is re-assessed and then recognised immediately in profit or loss.

7 D

		$	$
Dr.	Revenue	100 000	
Cr.	Cost of sales		100 000

Intra-group revenue must be eliminated in full from revenue as income and costs are wholly intra-group. As there is no unsold inventory at the year end and, therefore, no unrealised profit, the adjustment to costs is the same as the adjustment to revenue.

8 C

	$	$
Profit of Lay Co.		189 000
Profit of Hay Co. since acquisition 11 / 12 × $60 000		55 000
Goodwill impairment		
Consideration transferred	450 000	
NCI (10% × 460 000)	46 000	
Net assets of Hay Co.	(460 000)	
		(18 000)
Profit for the year	50% × 36 000	226 000

9 C

	$
NCI in Stereo's profit ($40 000 × 15%)	6 000
NCI share of impairment loss ($6 000 × 15%)	(900)
	5 100

The unrealised profit is dealt with in the selling company's books. In this case that is Radio.

ANSWERS TO QUICK REVISION QUESTIONS 4

1 B All of a subsidiary's assets and liabilities are included in the consolidated statement of financial position and then an amount to reflect those not owned is shown in the form of the non-controlling interest.
Share capital in the consolidated statement of financial position is only ever the investor's share capital.

2 B Consul cannot exercise significant influence over Warrior because it is controlled by another entity which ignores Consul's views. However, it has the largest shareholding and a board seat, so exercising significant influence over Admiral. Sultan is not so clear. As another entity also has significant influence over Sultan, it is likely that Consul does too.

3 D

	$m
Cost of investment	12.0
Group share of post-acquisition reserves (30% × 5)	1.5
	13.5

4 A Group gross profit will only include the gross profit of the parent and the subsidiary. The group's share of the profit of the associate is reported on a separate line below gross profit in the consolidated statement of profit or loss.

	$'000
Savoy	700
Spring	550
	1 250

5 C Statement (I) True – If K controls L then L will be a subsidiary, not an associate.
Statement (II) Untrue – There is a presumption that L would be an associate of K but this is rebuttable for example, if another party held say 70 per cent of the shares while K only held 30 per cent.
Statement (III) True – There is no elimination of balances for an associate as the associate is not part of the group.

6 B Mark up on cost = 20 000 / 80 000 × 100%
= 25%
Unrealised profit = $16 000 × 25 / 125 × 25%
= $800

7 A

	$
Investment brought forward	6 600 000
Profit after tax (420 000 – 180 000)	240 000
Dividends paid (bal fig)	(90 000)
Investment carried forward	6 750 000

8 C Share of profit of associate: 30% × 8 / 12 × $66 000 = $13 200
Carrying amount of associate: $400 000 + $13 200 = $413 200

9 A

	$
Income from associate (20% × $180 000)	36 000
Impairment in associate (see below)	(26 300)
	9 700
Cost of investment	420 000
Share of post acquisition profits (20% × 530 000)	106 000
	526 000
Impairment (5% × 526 000)	26 300

10 B

	$
AB's inventory	90 000
CD's inventory	38 000
	128 000

Remember that the associate's inventory is not added across on a line by line basis; therefore EF's $65 000 is not included in group inventory.

The unrealised profit to be eliminated is 30% × 25% × $20 000 = $1500, so a consolidation adjustment to debit the share of profit of associates and credit the investment in associates by $1500 is required. However this has no input on group inventory figures.

ANSWERS TO MODULE QUESTIONS

1

INVESTMENT	CRITERIA	REQUIRED TREATMENT IN GROUP ACCOUNTS
Subsidiary	Control (> 50 per cent rule)	Full consolidation (IFRS 10)
Associate	Significant influence (20 per cent + rule)	Equity accounting (IAS 28)
Investment which is neither of the above	No significant influence (< 20 per cent rule)	As for single company accounts

2 The group structure is:

P Co.

↓ 60 per cent

S Co.

Partly cancelling items are the components of P Co.'s investment in S Co., that is, ordinary shares and loan stock. Non-controlling shareholders have an interest in 40 per cent (8000/20 000) of S Co.'s ordinary shares, including reserves.

You should now total the assets and liabilities and produce workings for non-controlling interest, revaluation surplus and retained earnings as follows:

Workings

1 *Revaluation surplus*

	$
P Co.	–
Share of S Co.'s revaluation surplus (60% × 6 000)	3 600
	3 600

2 *Retained earnings*

	$
P Co.	22 000
Share of S Co.'s retained earnings (60% × 4 000)	2 400
	24 400

3 *Non-controlling interest*

	$
S Co.'s net assets (66 000 – 36 000)	30 000
× 40%	12 000

The results of the workings are now used to construct the consolidated statement of financial position.

P GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Property, plant and equipment		65 000
Current assets		53 000
Total assets		118 000
Equity and liabilities		
Equity attributable to parent		
Ordinary shares	40 000	
Revaluation surplus (W1)	3 600	
Retained earnings (W2)	24 400	
		68 000
Non-controlling interest (W3)		12 000
		80 000

	$	$
Non-current liabilities		
10% loan stock (26 000 – 8 000)		18 000
Current liabilities		20 000
Total equity and liabilities		118 000

Notes

(a) S Co. is a subsidiary of P Co. because P Co. owns 60 per cent of its ordinary capital.

(b) As always, the share capital in the consolidated statement of financial position is that of the parent alone. The share capital in S Co.'s statement of financial position was partly cancelled against the investment shown in P Co.'s statement of financial position, while the uncancelled portion was credited to the non-controlling interest.

(c) The figure for the non-controlling interest comprises the interest of outside investors in the share capital and reserves of the subsidiary. The uncancelled portion of S Co.'s loan stock is not shown as part of the non-controlling interest but is disclosed separately as a liability of the group.

3 A The non-controlling interest at any given reporting date is measured as:

	$
NCI as measured at acquisition	X
NCI share of profits made by the subsidiary since acquisition	X
	X

Therefore:

NCI as measured at acquisition	460 000
NCI share of post-acquisition profits (10% × (275 400 + 286 000))	56 140
	516 140

4 P CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	$	$
Assets		
Non-current assets		
Property, plant and equipment (120 000 + 100 000)		220 000
Current assets		
Inventories (50 000 + 60 000)	110 000	
Goods in transit (18 000 – 12 000)	6 000	
Receivables (40 000 + 30 000)	70 000	
Cash (4 000 + 6 000)	10 000	
		196 000
Total assets		416 000
Equity and liabilities		
Equity		
Ordinary shares, fully paid (parent)	100 000	
Retained earnings (95 000 + 28 000)	123 000	
		223 000
Non-current liabilities		
10% loan stock	75 000	
12% loan stock (50 000 × 60%)	30 000	
		105 000
Current liabilities		
Payables (47 000 + 16 000)	63 000	
Taxation (15 000 + 10 000)	25 000	
		88 000
Total equity and liabilities		416 000

Note especially how:

(a) The uncancelled loan stock in S Co. becomes a liability of the group

(b) The goods in transit is the difference between the current accounts ($18 000 – $12 000)

(c) The investment in S Co.'s shares is cancelled against S Co.'s share capital.

5 To prepare the consolidated statement of financial position, follow the steps below:

1. **Agree current accounts**

   Ping Co. has goods in transit of $2000 making its total inventory $3000 + $2000 = $5000 and its liability to Pong Co. $8000 + $2000 = $10 000.

   Cancel common items: these are the current accounts between the two companies of $10 000 each.

2. **Calculate goodwill**

   Goodwill

		Group	NCI
		$	$
Consideration transferred (W3)/fair value of NCI		38 734	9 000
Net assets acquired as represented by:			
Ordinary share capital	25 000		
Revaluation surplus on acquisition	5 000		
Retained earnings on acquisition	6 000		
Intangible asset – brand name	5 000		
	41 000		
Group/NCI %		(32 800)	(8 200)
Goodwill		5 934	800

   This goodwill (total $6734) must be capitalised in the consolidated statement of financial position.

3. **Consideration transferred**

	$
Cash paid	30 000
Contingent consideration: 10 000 × 1/(1.07^2)*	8 734
	38 734

   * Note that the contingent consideration has been discounted at 7 per cent for 2 years (1 July 20X7 to 1 July 20X9).

   However, at the date of the current financial statements, 30 June 20X8, the discount for one year has unwound. The amount of the discount unwound is:

	$
(10 000 × 1 / 1.07) – 8734	612

   So this amount will be charged to finance costs in the consolidated financial statements and the contingent consideration under liabilities will be shown as $9346 (8734 + 612).

4. **Calculate consolidated reserves**

   Consolidated revaluation surplus

	$
Ping Co	12 000
Share of Pong Co.'s post acquisition revaluation surplus	–
	12 000

   Consolidated retained earnings

	Ping	Pong
	$	$
Retained earnings per question	26 000	28 000
Less pre-acquisition		(6 000)
Discount unwound – finance costs	(612)	22 000
Share of Pong: 80% × $22 000	17 600	
	42 988	

5. **Calculate non-controlling interest at year end**

	$
Pong Co.'s net assets per question (65 000 – 7000)	58 000
Intangible asset (brand name)	5 000
	63 000
NCI share 20%	12 600
Goodwill (W2)	800
	13 400

6. **Prepare the consolidated statement of financial position**

PING CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

	$	$
Assets		
Non-current assets		
Property, plant and equipment ($50 000 + $40 000)		90 000
Intangible assets: goodwill (W2)		6 734
Brand name		5 000
Current assets		
Inventories ($5000 + $8000)	13 000	
Receivables ($16 000 + $7000)	23 000	
Cash	2 000	
		38 000
Total assets		139 734
Equity and liabilities		
Equity		
Ordinary shares	45 000	
Revaluation surplus (W4)	12 000	
Retained earnings (W4)	42 988	
		99 988
Non-controlling interest (W5)		13 400
		113 388
Current liabilities		
Trade payables ($10 000 + $7000)		17 000
Contingent consideration (W3)		9 346
Total equity and liabilities		139 734

6 To prepare the consolidated statement of financial position, follow the steps below:

1 *Goodwill*

	$	$
Consideration transferred		46 000
Net assets acquired as represented by		
Share capital	30 000	
Retained earnings	10 000	
		(40 000)
Goodwill		6 000

2 *Retained earnings*

	P Co. $	S Co. $
Retained earnings per question	45 000	22 000
Unrealised profit: 20% × $15 000		(3 000)
Pre-acquisition		(10 000)
		9 000
Share of S Co.	9 000	
Goodwill impairment loss	(1 500)	
	52 500	

P CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Non-current assets		
Property, plant and equipment	120 000	
Goodwill (6000 – 1500)	4 500	
		124 500
Current assets (W1)		55 000
Total assets		179 500
Equity and liabilities		
Equity		
Ordinary shares	100 000	
Retained earnings	52 500	
		152 500
Current liabilities (W2)		27 000
Total equity and liabilities		179 500

Workings

1 *Current assets*

	$	$
In P Co.'s statement of financial position		40 000
In S Co.'s statement of financial position	30 000	
Less S Co.'s current account with P Co. cancelled	(12 000)	
		18 000
		58 000
Less unrealised profit excluded from inventory valuation		(3 000)
		55 000

2 *Current liabilities*

	$
In P Co.'s statement of financial position	21 000
Less P Co.'s current account with S Co. cancelled	(12 000)
	9 000
In S Co.'s statement of financial position	18 000
	27 000

7 Singe Co. has made a profit of $24 000 ($43 000 – $19 000) for the year. In the absence of any direction to the contrary, this should be assumed to have arisen evenly over the year; $6000 in the three months to 31 March and $18 000 in the nine months after acquisition. The company's pre-acquisition retained earnings are therefore as follows:

	$
Balance at 31 December 20X4	19 000
Profit for three months to 31 March 20X5	6 000
Pre-acquisition retained earnings	25 000

The consolidation workings can now be drawn up.

1 *Goodwill*

	$	$
Consideration transferred		50 000
Net assets acquired represented by		
Ordinary share capital	10 000	
Retained earnings (pre-acquisition)	25 000	
	35 000	
Group share 80%		(28 000)
Goodwill attributable to group		22 000
Goodwill attributable to NCI		3 000
		25 000

2 *Retained earnings*

	Hinge Co.	Singe Co.
	$	$
Per question	47 000	43 000
Pre-acquisition (see above)		(25 000)
		18 000
Share of Singe: $18 000 × 80%	14 400	
	61 400	

3 *Non-controlling interest at reporting date*

	$
Singe Co. net assets (73 000 – 20 000)	53 000
× 20%	10 600
Goodwill	3 000
	13 600

HINGE CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$	$
Assets		
Property, plant and equipment		62 000
Goodwill (W1)		25 000
Current assets		128 000
Total assets		215 000
Equity and liabilities		
Equity		
Ordinary shares	100 000	
Retained earnings (W2)	61 400	
		161 400
Non-controlling interest (W3)		13 600
		175 000
Current liabilities		40 000
Total equity and liabilities		215 000

8 S Co.: carrying amount at disposal (at historical cost) = $4000 × 1½ / 4 = $1500
∴ Profit on disposal = $1100 (depreciation charge for the year = $500)

P Co.: carrying amount at disposal (at fair value) = $3000 × 1½ / 2 = $2250
∴ Profit on disposal for consolidation = $350 (depreciation for the year = $750)

The non-controlling interest would be credited with 20 per cent of both the profit on disposal and the depreciation charge as part of the one line entry in the consolidated statement of profit or loss and other comprehensive income.

9 Goodwill on consolidation of Kono Co.

	$m	$m
Consideration ($2.00 × 6m)		12.0
Fair value of net assets acquired		
Share capital	8.0	
Pre-acquisition reserves	4.4	
Fair value adjustments		
Property, plant and equipment (16.6 – 16.0)	0.6	
Inventories (4.2 – 4.0)	0.2	
	13.2	
Group share 75%		(9.9)
Goodwill		2.1

Notes on treatment

1. Share capital and pre-acquisition profits represent the book value (carrying amount) of the net assets of Kono Co. at the date of acquisition. Adjustments are then required to this book value in order to give the fair value of the net assets at the date of acquisition. For short-term monetary items, fair value is their carrying amount on acquisition.

2. IFRS 3 states that the fair value of property, plant and equipment should be determined by market value.
3. Raw materials should be valued at their replacement cost of $4.2m.
4. The rationalisation costs cannot be reported in pre-acquisition results under IFRS 3 as they are not a liability of Kono Co. at the acquisition date.

10 The unrealised profit on disposal which must be added to cost of sales in order to eliminate it from profit is:

	$
Proceeds	26 000
Carrying amount at date of disposal 6/10 × $40 000	(24 000)
	2 000

The increase in depreciation charge which must be deducted from cost of sales in order to increase profit is:

8 months depreciation on historic cost 8/12 × $40 000 / 10	2 667
8 months depreciation on transfer price 8/12 × $26 000 / 6	2 889
	222

Therefore, the overall adjustment to cost of sales is an increase of $1778 ($2000 – $222).

11 The shares in S Co. were acquired three months into the year. Only the post-acquisition proportion (9/12) of S Co.'s statement of profit or loss is included in the consolidated statement of profit or loss.

P CO. CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X5

	$
Revenue (170 + 60)	230 000
Cost of sales (65 + 27)	(92 000)
Gross profit	138 000
Administrative expenses (43 + 9)	(52 000)
Profit before tax	86 000
Income tax expense (23 + 6)	(29 000)
Profit for the year	57 000
Profit attributable to:	
Parent	49 800
Non-controlling interest (18 × 40%)	7 200
	57 000

STATEMENT OF CHANGES IN EQUITY

	Retained earnings $	Non-controlling interest $
Balance at 1 January 20X5	81 000	– *
Dividends paid (6000 × 40%)	(12 000)	(2 400)
Total comprehensive income for the year	49 800	7 200
Added on acquisition of subsidiary (W)	–	58 400
Balance at 31 December 20X5	118 800	63 200

* All of S Co.'s profits brought forward are pre-acquisition.

Working

	$
Added on acquisition of subsidiary:	
Share capital	100 000
Retained earnings brought forward	40 000
Profits Jan-Mar 20X5 (24 000 – 18 000)	6 000
	146 000
Non-controlling share 40%	58 400

12 BRODICK GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR TO 30 APRIL 20X7

	$'000
Revenue (1100 + 500)	1600
Cost of sales (630 + 300)	(930)
Gross profit	670
Administrative expenses (105 + 150)	(255)
Profit before tax	415
Income tax expense (65 + 10)	(75)
Profit for the year	340
Profit attributable to:	
Parent	332
Non-controlling interest (W1)	8
	340

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (extracts)

	Retained earnings $'000	Non-controlling interest $'000
Balance brought forward (W2, W3)	500	221.2
Dividends paid (30 000 – 24 000)	(200)	(6)
Total comprehensive income for the year	332	8
Balance carried forward	632	223.2

Workings

1 *Non-controlling interests*

	$'000
In Lamlash (20% × 40)	8

2 *Retained earnings brought forward*

	Brodick Co. $'000	Lamlash Co. $'000
Per question	460	106
Less pre-aqn		(56)
		50
Share of Lamlash: 80% × 50	40	
	500	

3 *Non-controlling interest brought forward*

	$'000
Share capital	1 000
Retained earnings	106
	1 106
Non-controlling share 20%	221.2

Note: The carried forward figures can be proved as follows:

Retained earnings 584 + 80% (116 – 56) = 632

Non-controlling interest 20% × (1 000 + 116) = 223.2

13 PARENT CO.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS

	$'000
Profit before tax of Parent and Subsidiaries	95
Share of profits of associate (50 × 40%)	20
Profit before tax	115
Income tax expense	(35)
Profit attributable to the members of Parent Co.	80

PARENT CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$'000
Assets	
Tangible non-current assets	220
Investment in associate (see note)	104
Current assets	100
Total assets	424
Equity and liabilities	
Share capital	250
Retained earnings (W)	174
Total equity and liabilities	424

Note:

	$'000
Investment in associate	
Cost of investment	60
Share of post-acquisition retained earnings (W)	24
Loan to associate	20
	104

Working

Retained earnings	Parent and Subsidiaries $'000	Associate $'000
Per question	150	100
Pre-acquisition		40
Post-acquisition		60
Group share in associate ($60 × 40%)	24	
Group retained earnings	174	

14 CONSOLIDATED STATEMENT OF PROFIT OR LOSS

	$
Share of profit of associate ((82 000 – 32 000) × 25%)	12 500

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$
Investment in associate	45 500

Working

	$
Cost of investment	38 000
Share of post-acquisition retained earnings ((82 000 – 32 000 – 20 000) × 25%)	7 500
	45 500

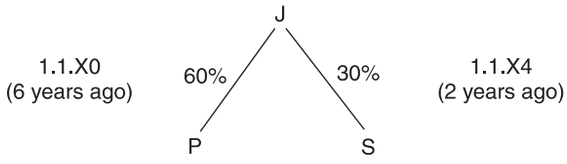
15 J GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$'000
Non-current assets	
Freehold property (W2)	3 570.0
Plant and machinery (795 + 375)	1 170.0
Investment in associate (W9)	475.2
	5 215.2
Current assets	
Inventory (W3)	855.0
Receivables (W4)	620.0
Cash (50 + 120)	170.0
	1 645.0
Total assets	6 860.2

	$'000
Equity and liabilities	
Equity	
Share capital	2 000.0
Retained earnings (W10)	1 776.2
	3 776.2
Non-controlling interest (W11)	894.0
	4 670.2
Non-current liabilities	
12% loan stock (500 + 100)	600.0
Current liabilities (W5)	1 590.0
Total equity and liabilities	6 860.2

Workings

1 *Group structure*



2 *Freehold property*

	$'000
J Co.	1 950
P Co.	1 250
Fair value adjustment	400
Additional depreciation (400 × 50% / 40) × 6 years (20X0-20X5)	(30)
	3 570

3 *Inventory*

	$'000
J Co.	575
P Co.	300
Provision for unrealised profit (100 × $^{25}/_{125}$)	(20)
	855

4 *Receivables*

	$'000
J Co.	330
P Co.	290
	620

5 *Current liabilities*

	$'000
J Co.: bank overdraft	560
trade payables	680
P Co.: trade payables	350
	1 590

6 *Provision for Unrealised Profit (PURP)*

	$'000
On sales to J (Parent Co.) 100 × 25/125	20.0
On sales to S (associate) 80 × 25/125 × 30%	4.8

7 *Fair value adjustments*

	Difference at acquisition $'000	Difference now $'000
Property	400	400
Additional depreciation: 200 × 6/40	–	(30)
	400	370

∴ Charge $30 000 to retained earnings

8 *Goodwill*

	$'000	$'000
P Co.		
Consideration transferred		1 000
Net assets acquired		
Share capital	1 000	
Retained earnings	200	
Fair value adjustment	400	
	1 600	
Group share 60%		(960)
Goodwill at acquisition		40
Impairment loss		(40)
		0

9 *Investment in associate*

	$'000
Cost of investment	500.00
Share of post-acquisition profit (390 – 150) × 30%	72.00
Less PUP (W6)	(4.80)
Less impairment loss	(92.00)
	475.20

10 *Retained earnings*

	J	P	S
	$'000	$'000	$'000
Retained earnings per question	1 460.0	885.0	390.0
Adjustments			
Unrealised profit (W6)		(20.0)	
Fair value adjustments (W7)		(30.0)	
		835.0	390.0
Less pre-acquisition reserves		(200.0)	(150.0)
	1 460.0	635.0	240.0
P: 60% × 635	381.0		
S: 30% × 240	72.0		
Less PUP on sales to associate (W6)	(4.8)		
Less impairment losses: P	(40.0)		
S	(92.0)		
	1 776.2		

11 *Non-controlling interest at reporting date*

	$'000
Net assets of P Co.	1 885.0
Fair value adjustment (W7)	370.0
Less PUP: sales to J Co.	(20.0)
	2 235.0
Non-controlling interest (40%)	894.0

MODULE 6
ANALYSIS OF FINANCIAL STATEMENTS

Learning objectives	Reference
Calculate, analyse and interpret financial ratios and their interrelationship in the financial statements.	LO6.1
Explain the limitations of financial statement analysis.	LO6.2

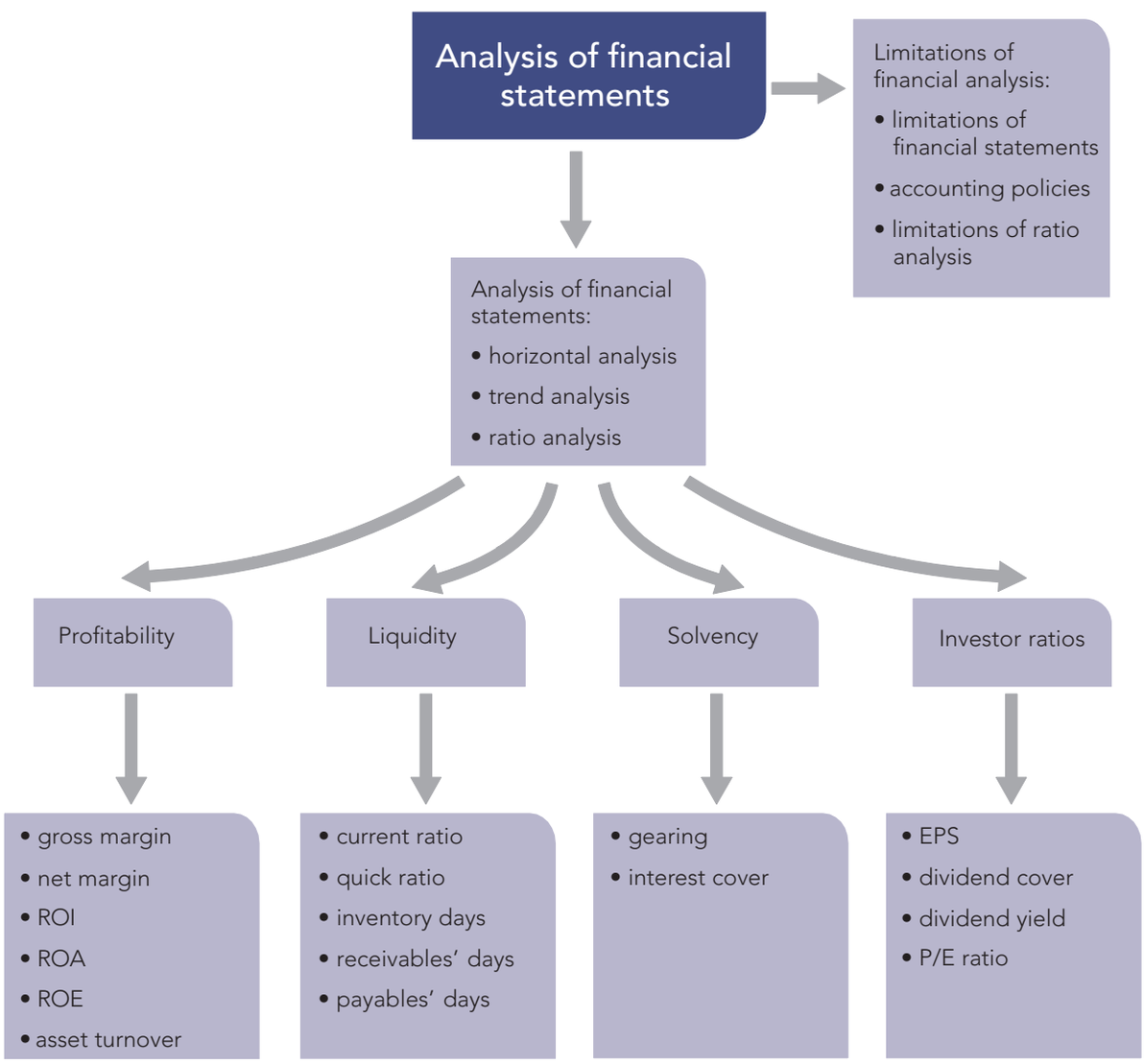
Topic list

1 Financial analysis: subject outline
2 Profitability
3 Solvency
4 Liquidity and efficiency
5 Investor ratios
6 Comprehensive question
7 Limitations of financial analysis

MODULE OUTLINE

This module looks at **interpretation of financial statements**. We deal with the calculation of ratios and how they are analysed and interpreted. We shall also consider the limitations of financial analysis.

The module content is summarised in the figure below.



Analysis of financial statements: Module summary diagram

BEFORE YOU BEGIN

If you have studied these topics before, you may wonder whether you need to study this module in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the module to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the module you can find the information, and you will also find a commentary at the back of the Study Guide.

1 What is horizontal analysis of financial statements? (Section 1)
2 What is trend analysis? (Section 1)
3 What are the broad groups of ratios that are relevant in any financial analysis? (Section 1.1)
4 How is return on investment (ROI) calculated? (Section 2.1)
5 What does ROI indicate? (Section 2.1)
6 How is asset turnover calculated? (Section 2.2)
7 What does asset turnover indicate? (Section 2.2)
8 What ratios indicate solvency? (Section 3)
9 What are the risks associated with a high level of leverage? (Section 3.2)
10 How is the current ratio calculated? (Section 4.2)
11 What is the difference between the current and quick ratio? (Section 4.2)
12 How is receivables' days calculated? (Section 4.3)
13 What does inventory days indicate? (Section 4.5)
14 What may an increase in payables' days indicate? (Section 4.6)
15 How is earnings per share calculated? (Section 5.1)
16 What do dividend cover and dividend yield indicate? (Sections 5.2 and 5.4)
17 What is the significance of a high P/E ratio? (Section 5.3)
18 What are the limitations of financial statements? (Sections 7.1 to 7.3)
19 What are the limitations of ratio analysis? (Section 7.4)

1 FINANCIAL ANALYSIS: SUBJECT OUTLINE

LO 6.1

Section overview

- Financial analysis compares the financial statements and ratios of a company with for example, prior years or industry averages.

When you look at a statement of financial position or statement of profit or loss and other comprehensive income, how do you decide whether the company is doing well or badly? Or whether it is financially strong or financially vulnerable?

Financial analysis is the practice of reviewing financial statements to answer these questions. It can be broken down into different types:

1. **Horizontal analysis** compares one company's financial statements directly with those of another similar company and considers why differences exist. For example, one company may have a higher profit than another with a similar revenue. A review of expenses may reveal that one company has lower interest costs which explains the difference. In the statements of financial position the more profitable company will likely have lower debt than the other company.
2. **Trend analysis** is a similar exercise which compares the financial statements of one company with those of the previous years. This form of analysis is useful in assessing the ongoing performance of a company, particularly when analysis relates to a number of years.
3. **Ratio analysis** calculates further values which add to the findings of basic horizontal or trend analysis. A ratio which should already be familiar to you is the gross profit margin. The majority of this module relates to common ratios and what they mean. As with other forms of analysis, there must be some form of comparative or benchmark for ratios. This may be ratios calculated for a competitor, for the same company in previous years, or industry averages.

1.1 RATIO ANALYSIS

Basic ratios can be grouped into four categories:

- profitability;
- solvency;
- liquidity/efficiency; and
- investor ratios.

Within each heading we will identify a number of ratios that are normally calculated and generally accepted as meaningful indicators. Each individual business must be considered separately however, so a ratio that is meaningful for a manufacturing company may be completely meaningless for a financial institution.

It must be stressed that ratio analysis on its own is not sufficient for interpreting company financial statements, and that there are **other items of information** which should be looked at, for example:

- the content of any **accompanying commentary** on the financial statements and other statements;
- the age and nature of the **company's assets**;
- **current and future developments** in the company's markets, at home and overseas, recent acquisitions or disposals of a subsidiary by the company;
- **unusual** items separately disclosed in the statement of profit or loss and other comprehensive income; and
- any other **noticeable features** of the report and financial statements, such as events after the end of the reporting period, contingent liabilities, a qualified auditors' report, the company's taxation position, and so on.

Worked Example: Calculating ratios

To illustrate the calculation of ratios throughout this module, the following **draft** statement of financial position and statement of profit or loss figures are used. Note that there are no items of other comprehensive income.

FURLONG CO. STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

	Notes	20X8	20X7
		$	$
Revenue	1	3 095 576	1 909 051
Operating profit before interest and tax	1	360 245	247 011
Interest		18 115	21 909
Profit before taxation		342 130	225 102
Income tax expense		74 200	31 272
Profit for the year		267 930	193 830
Earnings per share		12.8c	9.3c

FURLONG CO. STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X8

	Notes	20X8	20X7
		$	$
Assets			
Non-current assets			
Property, plant and equipment		802 180	656 071
Current assets			
Inventory		64 422	86 550
Receivables	2	1 002 701	853 441
Cash at bank and in hand		1 327	68 363
		1 068 450	1 008 354
Total assets		1 870 630	1 664 425
Equity and liabilities			
Equity			
Ordinary shares (2.1million)	4	210 000	210 000
Retained earnings		699 899	458 769
		909 899	668 769
Non-current liabilities			
10% loan stock 20X4/20Y0		100 000	100 000
Current liabilities	3	860 731	895 656
Total equity and liabilities		1 870 630	1 664 425

NOTES TO THE ACCOUNTS

		20X8	20X7
		$	$
1	*Sales revenue and profit*		
	Sales revenue	3 095 576	1 909 051
	Cost of sales	2 402 609	1 441 950
	Gross profit	692 967	467 101
	Administration expenses	332 722	220 090
	Operating profit	360 245	247 011
	Depreciation charged	15 107	120 147
2	*Receivables*		
	Amounts falling due within one year		
	Trade receivables	905 679	807 712
	Prepayments and accrued income	97 022	45 729
		1 002 701	853 441
3	*Current liabilities*		
	Trade payables	627 018	545 340
	Accruals and deferred income	81 279	280 464
	Income taxes	108 000	37 200
	Other taxes	44 434	32 652
		860 731	895 656

		20X8 $	20X7 $
4	*Share capital* Issued and fully paid ordinary shares	210 000	210 000
5	Dividends paid	20 000	–

2 PROFITABILITY

LO 6.1

Section overview

- Return on investment (ROI), and return on equity (ROE) are used by shareholders or the Board to assess the profitability of an entity and the performance of its management.

In our example, the company made a profit in both 20X8 and 20X7, and there was an increase in profit between one year and the next:

(a) of 52 per cent before taxation; and

(b) of 39 per cent after taxation.

Profit before taxation is generally thought to be a better figure to use than profit after taxation, because there might be unusual variations in the tax charge from year to year which would not affect the underlying profitability of the company's operations.

Another profit figure that should be calculated is EBIT, **earnings before interest and tax**. This is the amount of profit which the company earned before paying interest to the providers of loan capital. Loan capital is long-term loans, such as loan notes and bank loans, which are shown in the statement of financial position as non-current liabilities.

Formula to learn

Earnings before interest and tax is:

(a) profit after tax; **plus**

(b) interest; **plus**

(c) tax.

Published financial statements do not always give sufficient detail to determine how much of the interest payable is for long-term finance. We will assume in our example that all of the interest expense ($18 115) relates to long-term finance.

EBIT in our example is therefore:

	20X8 $	20X7 $
Profit before tax	342 130	225 102
Interest expense	18 115	21 909
EBIT	360 245	247 011

This shows a 46 per cent growth between 20X7 and 20X8.

2.1 RETURN ON INVESTMENT (ROI)

Return on investment is sometimes called return on capital employed (ROCE).

It is impossible to assess profits or profit growth properly without relating them to the **amount that has been invested in the company in order to earn the profits**. The most important profitability ratio is ROI which states the profit as a percentage of the amount of capital invested.

Investment (sometimes called capital employed)	=	Shareholders' equity plus non-current liabilities (**or** total assets *less* current liabilities)

Formula to learn

$$\text{ROI} = \frac{\text{Earnings before interest and taxation}}{\text{Total assets } \textit{less} \text{ current liabilities}} \times 100\%$$

We must **compare like with like** so if investment (capital) means share capital and reserves plus non-current liabilities, profit must mean the profit earned by this capital. This is EBIT, since interest is the return for loan capital.

In our example, investment = 20X8 $1 870 630 – $860 731 = $1 009 899
20X7 $1 664 425 – $895 656 = $768 769

These total figures are the total assets less current liabilities figures for 20X8 and 20X7 in the statement of financial position.

	20X8	20X7
ROI	$\frac{\$360\ 245}{\$1\ 009\ 899} = 35.7\%$	$\frac{\$247\ 011}{\$768\ 769} = 32.1\%$

What does a company's ROI tell us? What should we be looking for? There are three comparisons that can be made:

- The **change in ROI from one year to the next** can be examined. In this example, there has been an increase in ROI by about 4 percentage points from its 20X7 level.
- The **ROI being earned by other companies**, if this information is available, can be compared with the ROI of this company. Here the information is not available.
- A comparison of the ROI with **current market borrowing rates** may be made:
  - What would be the cost of extra borrowing to the company if it needed more loans, and is it earning a ROI that suggests it makes sufficient profits for more borrowing to be worthwhile?
  - Is the company making a ROI which suggests that it is getting value for money from its current borrowing?
  - Companies are a risky investment and commercial borrowing rates are a good independent yardstick against which company performance can be judged.

In this example, if we suppose that current market interest rates, say, for medium-term borrowing from banks, are around 10 per cent, then the company's actual ROI of 36 per cent in 20X8 would not seem low. On the contrary, it might seem high.

However, it is easier to spot a low ROI than a high one, because there is always a chance that the company's non-current assets, especially property, are **undervalued** in its statement of financial position, and so the investment figure might be unrealistically low. If the company had earned a ROI, not of 36 per cent, but of, say only 6 per cent, then its return would have been below current borrowing rates and so disappointingly low.

2.2 ANALYSING PROFITABILITY AND RETURN IN MORE DETAIL: THE SECONDARY RATIOS

We often sub-analyse ROI, to find out more about why the ROI is high or low, or better or worse than last year. There are two factors that contribute towards a return on investment, both related to sales revenue:

Formula to learn

Profit margin = Earnings before interest and tax/Revenue × 100%

(a) **Profit margin**. A company might make a high or low profit margin on its sales. For example, a company that makes a profit of 25c per $1 of sales is making a bigger return on its revenue than another company making a profit of only 10c per $1 of sales.

Formula to learn

Asset turnover = Revenue/Total assets *less* current liabilities

(b) **Asset turnover**. Asset turnover is a measure of how well the assets of a business are being used to generate sales. For example, if 2 companies each have assets of $100 000 and Company A makes sales of $400 000 per annum whereas Company B makes sales of only $200 000 per annum, Company A is making a higher revenue from the same amount of assets (twice as much asset turnover as Company B) and this will help A to make a higher return on investment than B. Asset turnover is expressed as 'x times' so that assets generate x times their value in annual sales. Here, Company A's asset turnover is 4 times and B's is 2 times.

Profit margin and asset turnover together explain the ROI and if the ROI is the primary profitability ratio, then the other two are the secondary ratios. The relationship between the three ratios can be shown mathematically.

Formula to learn

Profit margin × Asset turnover = ROI

$$\therefore \frac{\text{EBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Investment}} = \frac{\text{EBIT}}{\text{Investment}}$$

In our example:

	Profit margin		Asset turnover		ROI
(a) 20X8	$\frac{\$360\ 245}{\$3\ 095\ 576}$		$\frac{\$3\ 095\ 576}{\$1\ 009\ 899}$		$\frac{\$360\ 245}{\$1\ 009\ 899}$
	11.6%	×	3.07 times	=	35.7%
(b) 20X7	$\frac{\$247\ 011}{\$1\ 909\ 051}$		$\frac{\$1\ 909\ 051}{\$768\ 769}$		$\frac{\$247\ 011}{\$768\ 769}$
	12.9%	×	2.48 times	=	32.1%

In this example, the company's improvement in ROI between 20X7 and 20X8 is attributable to a higher asset turnover. Indeed, the profit margin has fallen a little. The higher asset turnover has more than compensated for this.

It is also worth commenting on the change in sales revenue from one year to the next. You may already have noticed that Furlong achieved sales growth of over 60 per cent from $1.9 million to $3.1 million between 20X7 and 20X8. This is very strong growth, and one of the most significant items in the statement of profit or loss and statement of financial position.

2.2.1 A WARNING ABOUT COMMENTS ON PROFIT MARGIN AND ASSET TURNOVER

It might be tempting to think that a high profit margin is good, and a low asset turnover means sluggish trading. In broad terms, this is so. There is a trade-off between profit margin and asset turnover, and you cannot consider one without allowing for the other:

- A **high profit margin** means a high profit per $1 of sales, but if this also means that sales prices are high, there is a strong possibility that sales revenue will be depressed because the high price is likely to reduce demand for the product, and so asset turnover is lower.
- A **high asset turnover** means that the company is generating a lot of sales, but to do this it might have to keep its prices down and so accept a low profit margin per $1 of sales.

Consider the following:

Company A		Company B	
Sales revenue	$1 000 000	Sales revenue	$4 000 000
Investment (net assets)	$1 000 000	Investment (net assets)	$1 000 000
EBIT	$200 000	EBIT	$200 000

These figures would give the following ratios.

$$\text{ROI} = \frac{\$200\,000}{\$1\,000\,000} = 20\% \qquad \text{ROI} = \frac{\$200\,000}{\$1\,000\,000} = 20\%$$

$$\text{Profit margin} = \frac{\$200\,000}{\$1\,000\,000} = 20\% \qquad \text{Profit margin} = \frac{\$200\,000}{\$4\,000\,000} = 5\%$$

$$\text{Asset turnover} = \frac{\$1\,000\,000}{\$1\,000\,000} = 1 \qquad \text{Asset turnover} = \frac{\$4\,000\,000}{\$1\,000\,000} = 4$$

The companies have the same ROI, but it is arrived at in very different ways. Company A operates with a low asset turnover and a comparatively high profit margin whereas company B carries out much more business, but on a lower profit margin. Company A could be operating at the luxury end of the market, while company B may be operating at the popular end of the market. Alternatively, company A and company B could be operating in different industry sectors.

2.2.2 RETURN ON ASSETS (ROA)

Return on assets (ROA) is another version of ROI. It is calculated using average total assets, rather than total assets less current liabilities. The statement of financial position of Furlong Co. shows total assets for 20X8 as $1 870 630 and total assets for 20X7 as $1 664 425.

Formula to learn

$$\text{Return on assets (ROA)} = \frac{\text{Earnings before interest and tax}}{\text{Average total assets}} \times 100\%$$

ROI shows the return on the **total capital employed in financing the business** (shareholders' funds plus borrowings) and asset turnover based on capital employed shows the sales revenue generated by that capital. **ROA shows the return on the assets employed in the business** and asset turnover based on assets shows the **sales revenue generated by those assets**.

In our example:

	20X8	20X7
ROA	$\frac{\$360\,245}{\$1\,767\,527} = 20.3\%$	$\frac{\$247\,011}{\$1\,664\,425} = 14.8\%$

The average assets for 20X8 are calculated as: ((1 870 630 + 1 664 425)/2) = 1 767 527. We do not have the information needed to calculate an average for 20X7, so the 20X7 ROA is based on year end assets.

As before, the ratio can be analysed further:

	Profit margin		Asset turnover (average total assets)		ROA
(a) 20X8	$\frac{\$360\,245}{\$3\,095\,576}$		$\frac{\$3\,095\,576}{\$1\,767\,527}$		$\frac{\$360\,245}{\$1\,767\,527}$
	11.6%	×	1.75 times	=	20.3%
(b) 20X7	$\frac{\$247\,011}{\$1\,909\,051}$		$\frac{\$1\,909\,051}{\$1\,664\,425}$		$\frac{\$247\,011}{\$1\,664\,425}$
	12.9%	×	1.14 times	=	14.8%

Return on assets and asset turnover based on total assets are often used to assess the performance of management as management are responsible for using the entity's assets to generate profit.

What is considered an acceptable return on assets depends upon the type of business and therefore how many assets are recognised in the financial statements. For example, a manufacturer will have (and will depend on) a high level of tangible assets (plant, machinery and factory buildings) to generate revenue and profits. Other types of business, such as a service provider, will not. A service provider relies on the expertise of its staff to generate profit. Human resources and intellectual capital are intangible assets, but because they cannot be measured reliably they are not recognised as assets in the statement of financial position. For this reason, ROA and asset turnover can be relatively meaningless for some types of business such as information technology companies.

ROA can also be calculated for separate categories of assets. For example, many companies might calculate a return on operating assets (normally property, plant and equipment).

$$\frac{\text{Earnings before interest and tax}}{\text{Tangible non-current assets}}$$

This measures the profit generated by the assets that are actually used to manufacture and/or sell goods.

2.3 RETURN ON EQUITY (ROE)

Return on equity (ROE) is another variation on return on investment (ROI). It looks at profit from the **perspective of equity investors**. It measures the return that equity investors get on the funds they have invested. (This contrasts with ROI, which measures return on investment for the company as a whole.)

Formula to learn

$$\textbf{ROE} = \frac{\text{Profit after tax and preference dividend}}{\text{Shareholders' equity}} \times 100\%$$

As before, we must **compare like with like.** The return on equity shareholders' funds is the profit that 'belongs' to them: profit **after** interest, tax and preference dividends.

In our example, ROE is calculated as follows:

	20X8	20X7
ROE	$\frac{\$267\ 930}{\$909\ 899} = 29.4\%$	$\frac{\$193\ 830}{\$668\ 769} = 29.0\%$

ROE is regarded as an important overall measure of the way in which management use the company's assets to generate profits for shareholders. It is used in a similar way to ROI and ROA:

(a) It is compared with the ROE of **previous periods**; the ROE of **other companies**; and with **current market rates of borrowing**.

(b) It is **analysed** into its **secondary components**.

2.3.1 ANALYSING ROE

ROE can be broken down into three separate components:

1. **profit margin;**
2. **asset turnover; and**
3. **leverage or gearing.**

Formula to learn

Profit margin × Asset turnover × Assets to equity = ROE

$$\frac{\text{Profit after tax and preference dividend}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}} = \text{ROE}$$

In our example:

	Net profit margin		Asset turnover (net assets)		Assets to equity		ROE
(a) 20X8	$\frac{\$267\,930}{\$3\,095\,576}$		$\frac{\$3\,095\,576}{\$1\,009\,899}$		$\frac{\$1\,009\,899}{\$909\,899}$		$\frac{\$267\,930}{\$909\,899}$
	8.7%	×	3.06 times	×	1.11 times	=	29.4%
(b) 20X7	$\frac{\$193\,830}{\$1\,909\,051}$		$\frac{\$1\,909\,051}{\$768\,769}$		$\frac{\$768\,769}{\$668\,769}$		$\frac{\$193\,830}{\$668\,769}$
	10.2%	×	2.48 times	×	1.15 times	=	29.0%

We can see that ROE has stayed more or less the same over the two years. This is deceptive. Net profit margin has fallen by 1.5 percentage points but (as we saw earlier) asset turnover has risen. The company is less profitable but the assets are being used more efficiently than before. The assets to equity ratio (also known as the equity multiplier) has fallen slightly. Shareholders' equity has increased, while the amount of debt has remained the same. This indicates that the company's gearing, or leverage, has fallen slightly.

Gearing will be discussed in more detail later in this module, but the fact that gearing has fallen means that there is now slightly less risk attached to the shareholders' investment.

Suppose that a company has the following ratios:

	Net profit margin		Asset turnover (net assets)		Assets to equity		ROE
(a) 20X9	7.5%	×	2 times	×	2 times	=	30%
(b) 20X8	10%	×	2.5 times	×	1.1 times	=	27.5%

This company is showing an increase in ROE despite the fact that both its net profit margin and asset turnover have fallen. The increase in ROE has been caused by the sharp increase in the assets to equity ratio, but this is a worrying sign. The company is less profitable and fewer sales are being generated from the company's assets than before. In addition, gearing has risen because the company has taken on more long-term debt. The shareholders appear to be receiving a slightly better return on their investment, but they are also bearing much more risk.

2.4 GROSS PROFIT MARGIN, NET PROFIT MARGIN AND PROFIT ANALYSIS

Formula to learn

$$\textbf{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales}} \times 100\%$$

$$\textbf{Net profit margin} = \frac{\text{EBIT}}{\text{Sales}} \times 100\%$$

If there is sufficient detail in the statement of profit or loss and other comprehensive income, you will be able to calculate the gross profit margin and the net (operating) profit margin (based on earnings before interest and tax). **Looking at the two together** can be quite informative.

For example, suppose that a company has the following summarised statement of profit or loss for two consecutive years:

	Year 1	Year 2
	$	$
Revenue	70 000	100 000
Cost of sales	42 000	55 000
Gross profit	28 000	45 000
Expenses	21 000	35 000
Profit before tax	7 000	10 000

Although the net profit margin is the same for both years at 10 per cent, the gross profit margin is not.

In Year 1 it is: $\frac{\$28\,000}{\$70\,000} = 40\%$

and in Year 2 it is: $\frac{\$45\,000}{\$100\,000} = 45\%$

The improved gross profit margin has not led to an improvement in the profit before tax margin. This is because expenses as a percentage of sales have risen from 30 per cent in Year 1 to 35 per cent in Year 2.

3 SOLVENCY

LO 6.1

Section overview

- Solvency is the availability of cash to meet longer term financial commitments as they fall due.

Debt ratios are concerned with **how much the company owes in relation to its size**, whether it is getting into more debt or repaying debt, and whether its debt burden seems heavy or light.

- When a company is heavily in debt, banks and other potential lenders may be unwilling to advance further funds.
- When a company is earning only a modest profit before interest and tax, and has a heavy debt burden, there will be very little profit left over for shareholders after the interest charges have been paid. And so, if interest rates were to rise (on bank overdrafts and so on) or the company were to borrow even more, it might soon be incurring interest charges in excess of EBIT. This might eventually lead to the liquidation of the company.

These are two big reasons why companies should keep their debt burden under control. There are two ratios that are particularly worth looking at, the gearing ratio and interest cover.

3.1 GEARING/LEVERAGE

Gearing or leverage is concerned with a company's **long-term capital structure**. Gearing represents the proportion of the company's financing on which a return must be paid regardless of profitability.

We can think of a company as consisting of non-current assets and net current assets (i.e. working capital, which is current assets minus current liabilities). These assets must be financed by the long-term capital of the company, which is one of two things:

- Issued share capital which can be divided into:
  - Ordinary shares plus other equity (e.g. reserves)
  - Non-redeemable preference shares (unusual)
- Long-term debt including redeemable preference shares.

Redeemable preference share capital is normally classified as a non-current liability in accordance with IAS 32 *Financial Instruments: Presentation*, and preference dividends (paid or accrued) are included in finance costs in the statement of profit or loss and other comprehensive income.

The **capital gearing ratio** is a measure of the proportion of a company's capital that is debt. It is measured as follows:

Formula to learn

$$\text{Gearing} = \frac{\text{Interest bearing debt}}{\text{Shareholders' equity} + \text{interest bearing debt}} \times 100\%$$

There is **no absolute limit** to what a gearing ratio ought to be. A company with a gearing ratio of more than 50 per cent is said to be high geared (whereas low gearing means a gearing ratio of less than 50 per cent). Many companies are high geared, but if a high geared company is becoming increasingly high geared, it is likely to have difficulty in the future when it wants to borrow even more, unless it can also boost its shareholders' equity, either with retained profits or by a new share issue.

Capital gearing measures gearing for the company as a whole. There are several variations in the way that the gearing ratio can be calculated.

Formula to learn

$$\text{Assets to equity ratio} = \frac{\text{Non-current assets + net current assets}}{\text{Shareholders' equity}} \times 100\%$$

$$\text{Debt to total assets ratio} = \frac{\text{Interest bearing debt}}{\text{Total assets}} \times 100\%$$

The assets to equity ratio (also known as the equity multiplier) measures gearing from the viewpoint of the equity investors. Gearing is one of the factors that influence the return they receive on their investment.

The debt to total assets ratio is used to measure the extent to which a company's assets are financed by debt, rather than by equity. When companies make major asset purchases, for example to build or equip a new retail outlet, or to replace plant, they may need to raise finance specifically for this purpose. Capital expenditure may be financed by a share issue, or by taking out a long-term loan, or by a mixture of the two. Like return on assets (ROA), this ratio is most useful for a traditional type of business which uses non-current assets to generate revenue. Where a company has financed its operations with short term borrowings, including bank overdrafts, the ratio is sometimes calculated as:

$$\frac{\text{Total assets}}{\text{Total liabilities}}$$

Note that gearing can also be looked at conversely, by calculating the proportion of total assets financed by equity, and which may be called the equity to assets ratio. It is calculated as follows:

Formula to learn

$$\text{Equity to assets ratio} = \frac{\text{Shareholders' equity}}{\text{Non-current assets + net current assets}} \times 100\%$$

or

$$\frac{\text{Shareholders' equity}}{\text{Total assets less current liabilities}}$$

In the example of Furlong, the company has a low gearing ratio. It has no preference share capital and its only long-term debt is the 10 per cent loan stock. The assets to equity ratios are therefore high, while the debt to total assets ratio is very low.

		20X8	20X7
Gearing ratio	=	$\frac{\$100\,000}{\$1\,009\,899}$ = 9.9%	$\frac{\$100\,000}{\$768\,769}$ = 13.0%
Assets to equity	=	$\frac{\$1009\,899}{\$909\,899}$ = 1.11 times	$\frac{\$768\,769}{\$668\,769}$ = 1.15 times
Debt to total assets	=	$\frac{\$100\,000}{\$1870\,630}$ = 5.3%	$\frac{\$100\,000}{\$1664\,425}$ = 6.0%
Equity to assets ratio	=	$\frac{\$909\,899}{\$1\,009\,899}$ = 90.1%	$\frac{\$668\,769}{\$768\,769}$ = 87.0%

3.2 THE IMPLICATIONS OF HIGH OR LOW GEARING

Gearing or leverage is, among other things, an attempt to **quantify the degree of risk involved in holding share capital in a company**, risk both in terms of the company's ability to remain in business and in terms of expected ordinary dividends from the company. The problem with a highly geared company is that, by definition, there is a lot of debt. Debt generally carries a fixed rate of interest (or fixed rate of dividend if in the form of preference shares), hence there is a given (and large) amount to be paid out from profits to holders of debt before arriving at a residue available for distribution to the holders of equity. Consider this example:

	Company A $'000	Company B $'000	Company C $'000
Ordinary shares	600	400	300
Retained earnings	200	200	200
Revaluation reserve	100	100	100
	900	700	600
6% preference shares (redeemable)	–	–	100
10% loan stock	100	300	300
Investment (capital employed)	1 000	1 000	1 000
Gearing ratio	10%	30%	40%
Equity to assets ratio	90%	70%	60%

Now suppose that each company makes a profit before interest and tax of $50 000, and the rate of tax on company profits is 30 per cent. Amounts available for distribution to equity shareholders will be as follows:

	Company A $'000	Company B $'000	Company C $'000
Earnings before interest and tax	50	50	50
Interest/preference dividend	10	30	36
Taxable profit	40	20	14
Taxation at 30%	12	6	4
Profit for the period	28	14	10

If in the subsequent year earnings before interest and tax falls to $40 000, the amounts available to ordinary shareholders will become as follows:

	Company A $'000	Company B $'000	Company C $'000
Earnings before interest and tax	40	40	40
Interest/preference dividend	10	30	36
Taxable profit	30	10	4
Taxation at 30%	9	3	1
Profit for the period	21	7	3
Note the following:			
Gearing ratio	10%	30%	40%
Equity to assets ratio	90%	70%	60%
Change in EBIT	–20%	–20%	–20%
Change in profit available for ordinary shareholders	–25%	–50%	–70%

The more highly geared the company, the greater the risk that little (if any) profit/funds will be available to distribute by way of dividends to the ordinary shareholders. The example clearly illustrates this fact. The more highly geared the company, the greater the percentage change in profit available for ordinary shareholders for any given percentage change in profit before interest and tax. The relationship similarly holds when profits increase, and if EBIT had risen by 20 per cent rather than fallen, the largest percentage change in profit available for ordinary shareholders (this time an increase) will be for the highly geared company. This means that there will be greater **volatility** of amounts available for ordinary shareholders, and presumably therefore greater volatility in dividends paid to those shareholders when a company is highly geared. That is the risk: shareholders in a company that has high gearing may do extremely well or extremely badly without a particularly large movement in the EBIT of the company.

The risk of a company's inability to remain in business was referred to earlier. Gearing or leverage is relevant to this. A highly geared company has a large amount of interest to pay annually. If those borrowings are **'secured'** in any way then the **holders of the debt are entitled to force the company** to **sell secured assets to pay overdue interest**. Clearly, the more highly geared a company the more likely this is to occur when and if profits fall.

3.3 INTEREST COVER

The interest cover ratio shows whether a company is earning enough profits before interest and tax to pay its interest costs comfortably, or whether its interest costs are high in relation to the size of its profits, so that a fall in EBIT could have a significant effect on profits available for ordinary shareholders.

Formula to learn

$$\text{Interest cover} = \frac{\text{Earnings before interest and tax}}{\text{Interest charges}}$$

An interest cover of 2 times or less would be low, and should probably exceed 3 times before the company's interest costs are considered within acceptable limits.

Returning to the example of Companies A, B and C we looked at in Section 3.2, the interest cover is as follows:

	Company A	Company B	Company C
(a) When EBIT was $50 000 =	$50 000	$50 000	$50 000
	$10 000	$30 000	$36 000
	5 times	1.67 times	1.39 times
(b) When EBIT was $40 000 =	$40 000	$40 000	$40 000
	$10 000	$30 000	$36 000
	4 times	1.33 times	1.11 times

Both B and C have a low interest cover, which is a warning to ordinary shareholders that their profits and dividends are highly vulnerable to even small changes in EBIT.

Question 1: Interest cover

Returning to the example of Furlong, what is the company's interest cover, and what does this reveal? (The answer is at the end of the module.)

4 LIQUIDITY AND EFFICIENCY

LO 6.1

Section overview

- The current and quick ratios reveal a company's ability to pay its debts as they fall due (its liquidity). Efficient management of working capital revealed by efficiency ratios will contribute to a healthy liquidity position.

Profitability is of course an important aspect of a company's performance and gearing or leverage is another. Neither, however, addresses directly the key issue of **liquidity**.

Definition

Liquidity is the availability of sufficient funds to meet short-term financial commitments as they fall due. Liquidity involves the management of liquid assets and short-term debt.

Liquid assets are:

- cash;
- short-term financial investments for which there is a ready market;
- trade receivables (because they will pay what they owe within a reasonably short period of time);
- inventories (if they are expected to be sold in a reasonably short period of time); and
- bills of exchange receivable (because like ordinary trade receivables, these represent amounts of cash due to be received within a relatively short period of time).

In summary, **liquid assets are current asset items that will or could soon be converted into cash, and cash itself**.

A company obtains liquid assets when it sells goods and services or non-current assets and when it issues shares for cash or takes out a new loan. Clearly, a company cannot repeatedly sell non current assets or keep on issuing shares and raising loans. To maintain liquid assets a company must make sales revenue and profits. But profits do not always lead to increases in liquidity because funds generated from trading may be immediately invested in non-current assets or paid out as dividends.

A company needs liquid assets to meet its debts when they fall due. Payments are continually made for operating expenses and other costs, and there is a **cash cycle** from trading activities of cash coming in from sales and cash going out for expenses.

4.1 THE CASH CYCLE

To help you to understand liquidity ratios, it is useful to begin with a brief explanation of the cash cycle. The cash cycle describes **the flow of cash out of a business and back into it again as a result of normal trading operations**.

Cash goes out to pay suppliers, wages and salaries and other expenses. A business might hold inventory for a while and then sell it. Cash will come back into the business from sales. The main points about the cash cycle are as follows:

- The timing of cash flows in and out of a business does not always coincide with the time when sales and costs of sales occur. **Cash outflows can be postponed by taking credit from suppliers. Cash inflows can be delayed by giving credit to customers.**

- **The time between making a purchase and making a sale affects cash flows**. If inventories are held for a long time, the delay between the cash payment for inventory and cash receipts from selling it will also be a long one.
- **Holding inventories and having receivables can therefore be seen as two reasons why cash receipts are delayed.** Another way of saying this is that if a company invests in working capital, its cash position will show a corresponding decrease.
- Similarly, **taking credit from suppliers can be seen as a reason why cash payments are delayed**. The company's liquidity position will worsen when it has to pay the suppliers, unless it can get more cash in from sales and receivables in the meantime.

The liquidity ratios and working capital turnover ratios are used to test a company's liquidity, length of cash cycle, and investment in working capital.

4.2 LIQUIDITY RATIOS: CURRENT RATIO AND QUICK RATIO

The 'standard' test of liquidity is the **current ratio**.

Formula to learn

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The idea behind this is that a company should have enough current assets that give a promise of 'cash to come' to meet its future commitments to pay off its current liabilities. Obviously, a **ratio in excess of 1 should be expected**. Otherwise, there would be the prospect that the company might be unable to pay its debts on time. In practice, a ratio comfortably in excess of 1 should be expected, but what is 'comfortable' varies between different types of businesses.

Companies are not always able to convert all current assets into cash quickly. In particular, some manufacturing companies might hold large quantities of raw material inventories, which must be used in production to create finished goods inventory. These might be warehoused for a long time, or sold on lengthy credit. In such companies, inventories are not very 'liquid' assets, because the cash cycle is so long. For these companies, we calculate an additional liquidity ratio, known as the quick ratio or acid test ratio which ignores inventories.

The **quick ratio**, or **acid test ratio**, is calculated as follows:

Formula to learn

$$\text{Quick ratio} = \frac{\text{Current assets } \textit{less} \text{ inventory}}{\text{Current liabilities}}$$

Both the current ratio and the quick ratio offer an indication of the company's liquidity position, but the absolute figures **should not be interpreted too literally**. It is often theorised that an acceptable current ratio is 1.5 and an acceptable quick ratio is 0.8, but these should only be used as a guide. Different businesses operate in very different ways. A supermarket group for example, might have a current ratio of 0.52 and a quick ratio of 0.17. Supermarkets have low receivables (supermarkets do not give credit to customers), low cash (good cash management), medium inventories (high inventories but quick turnover, particularly in view of perishability) and very high payables.

Compare this with a manufacturing and retail organisation, with a current ratio of 1.44 and a quick ratio of 1.03. Such businesses operate with liquidity ratios closer to the standard.

What is important is the **trend** of these ratios. From this, it is easy to ascertain whether liquidity is improving or deteriorating. If a supermarket has traded for the last 10 years (very successfully) with current ratios of 0.52 and quick ratios of 0.17 then it should be supposed that the company can continue in business with those levels of liquidity. If in the following year the current ratio fell to 0.38 and the quick ratio to 0.09, then further investigation into the liquidity situation would be appropriate. It is the **relative** position that is far more important than the **absolute** figures.

Don't forget the opposing problem of having too much liquidity. A current ratio and a quick ratio can get **bigger than they need to be**. A company that has large volumes of inventories or receivables or idle cash might be over-investing in working capital, and tying up more funds in the business than it needs to. This would suggest poor management of receivables (credit), inventories or cash by the company.

Using our example (Furlong) above these ratios would be as follows:

	20X8	20X7
Current ratio	= 1 068 450/860 731	= 1 008 354/895 656
	= 1.24	= 1.13
Acid test ratio	= (1 068 450 – 64 422)/860 731	= (1 008 354 – 86 550)/895 656
	= 1.17	= 1.03

4.3 EFFICIENCY RATIOS: CONTROL OF RECEIVABLES AND INVENTORIES

A useful measure of the average length of time it takes for a company's customers to pay what they owe is the accounts receivable collection period (receivables' days).

Formula to learn

The estimated average accounts receivable collection period is calculated as:

$$\text{Receivables' days} = \frac{\text{Trade receivables}}{\text{Sales}} \times 365 \text{ days}$$

The figure for sales should be taken as the sales revenue figure in the statement of profit or loss. Ideally any **cash sales should be excluded** – this ratio should use credit sales – although in practice this may be impossible. The trade receivables are not the total figure for receivables in the statement of financial position, which includes prepayments and non-trade receivables. The trade receivables figure will be itemised in an analysis of the receivable total, in a note to the financial statements.

The estimate of the accounts receivable collection period is **only approximate because**:

(a) The value of receivables in the statement of financial position might be abnormally high or low compared with the 'normal' level the company usually has.

(b) Sales revenue in the statement of profit or loss is exclusive of sales taxes, but receivables in the statement of financial position are inclusive of sales tax. We are not strictly comparing like with like.

Sales are usually made on 'normal credit terms' of payment within a stated number of days. A collection period significantly in excess of this might be representative of poor management. However, some companies must allow generous credit terms to win customers. Exporting companies in particular may have to carry large amounts of receivables, and so their average collection period might be long.

The **trend of the collection period over time** is useful. If the collection period is increasing year on year, this is probably indicative of a poorly managed credit control function (and potentially therefore a poorly managed company).

4.4 ACCOUNTS RECEIVABLE COLLECTION PERIOD: EXAMPLES

Using various types of company as examples, the collection period for each of the companies is as follows.

Company	$\frac{\text{Trade receivables}}{\text{Sales}}$	Collection period (× 365)	Previous year	Collection period (× 365)
Supermarket	$\frac{\$5\,016}{\$284\,986}$ =	6 days	$\frac{\$3\,977}{\$290\,668}$ =	5 days
Manufacturer	$\frac{\$458.3\text{m}}{\$2\,059.5\text{m}}$ =	81 days	$\frac{\$272.4\text{m}}{\$1\,274.2\text{m}}$ =	78 days
Sugar refiner and seller	$\frac{\$304.4\text{m}}{\$3\,817.3\text{m}}$ =	29 days	$\frac{\$287.0\text{m}}{\$3\,366.3\text{m}}$ =	31 days

The differences in collection period reflect the differences between the types of business. Supermarkets have hardly any trade receivables at all, whereas manufacturing companies have far more. The collection periods are fairly constant from the previous year for all three companies.

4.5 INVENTORY TURNOVER

Another useful ratio is the inventory turnover period (inventory days). This figure indicates the average number of days that items of inventory are held. As with the average receivable collection period, it is only an approximate figure, but one which is useful for comparing changes year on year.

Formula to learn

$$\text{Inventory turnover period} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

Inventory turnover can be calculated in terms of the number of times in a year that inventory is replaced in the business (or 'turned over'). In this case the ratio is calculated as:

Formula to learn

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventory}}$$

An inventory turnover period of five days would correspond to inventory turnover of 73 times. In other words, inventory is sold and replaced every five days, or 73 times each year.

However inventory turnover is calculated, it is another measure of how vigorously a business is trading. A lengthening inventory turnover period (or reducing inventory turnover) from one year to the next indicates:

- a slowdown in trading; or
- a build-up in inventory levels, perhaps suggesting that the investment in inventories is becoming excessive.

Generally the **higher the inventory turnover the better**, i.e. the lower the turnover period the better, but several aspects of inventory holding policy have to be balanced:

- lead times (the time between ordering and receiving goods);
- seasonal fluctuations in sales;
- alternative uses of warehouse space;
- bulk buying discounts; and
- likelihood of inventory perishing or becoming obsolete.

Worked Example: Inventory turnover period

The estimated inventory turnover periods for a supermarket are as follows:

Company	$\frac{\text{Inventory}}{\text{Cost of sales}}$	Inventory turnover period (× 365 days)	Previous year
Supermarket	$\frac{\$15\,554K}{\$254\,571K}$	× 365 = 22 days	$\frac{\$14\,094K}{\$261\,368K}$ × 365 = 20 days

Adding together the inventory turnover period and receivables collection period gives an indication of how soon inventory is converted into cash. Both receivables collection period and inventory turnover period therefore give us a further indication of the company's liquidity.

Using example of Furlong above:

	20X8	20X7
Receivables days	= 1 002 701 / 3 095 576 × 365	= 853 441 / 1 909 051 × 365
	= 118 days	= 163 days
Inventory days	= 64 422 / 2 402 609 × 365	= 86 550 / 1 441 950 × 365
	= 10 days	= 22 days
Total	= 128 days	= 185 days

4.6 ACCOUNTS PAYABLE PAYMENT PERIOD

Another useful ratio is payables days. This figure indicates the average number of days credit taken from suppliers. As with the average receivable collection period, it is only an approximate figure, but one which is useful for comparing changes year on year.

Formula to learn

Accounts payable payment period (payables' days) is ideally calculated by the formula:

$$\frac{\text{Trade accounts payable}}{\text{Purchases}} \times 365 \text{ days}$$

It is rare to find purchases disclosed in published financial statements but they can be approximated as cost of sales plus increase (or minus decrease) in inventory.

For instance, we can calculate the 20X8 purchases of Furlong as (2 402 609 – (86 550 – 64 422))

= $2 380 481

This would give an accounts payable payment period of (627 018 / 2 380 481) × 365 = 96 days.

The payables payment period helps to assess a company's liquidity; an increase is often a sign of lack of long-term finance or poor management of current assets, resulting in the use of extended credit from suppliers, increased bank overdraft and so on.

Question 2: Liquidity and working capital

Calculate liquidity and working capital ratios from the financial statements of TEB Co., a business which provides service support (cleaning etc.) to customers worldwide. Comment on the results of your calculations.

	20X7 $m	20X6 $m
Sales revenue	2 176.2	2 344.8
Cost of sales	1 659.0	1 731.5
Gross profit	517.2	613.3
Current assets		
Inventories	42.7	78.0
Receivables (note 1)	378.9	431.4
Short-term deposits and cash	205.2	145.0
	626.8	654.4
Current liabilities		
Loans and overdrafts	32.4	81.1
Tax on profits	67.8	76.7
Accruals	11.7	17.2
Payables (note 2)	487.2	467.2
	599.1	642.2
Net current assets	27.7	12.2
Notes		
1 Trade receivables	295.2	335.5
2 Trade payables	190.8	188.1
3 Inventories at the end of 20X5 were $83.5m		

(The answer is at the end of the module.)

Question 3: Operating cycle

(a) Calculate the cash cycle for Moribund plc for 20X2 on the basis of the following information:

		$
Inventory:	raw materials	150 000
	work in progress	60 000
	finished goods	200 000
Purchases		500 000
Trade accounts receivable		230 000
Trade accounts payable		120 000
Sales		900 000
Cost of goods sold		750 000

Tutorial note: The cash cycle is calculated as inventory days plus receivables days minus payables days.

(b) List the steps which might be taken in order to improve the cash cycle.

(The answer is at the end of the module.)

5 INVESTOR RATIOS

Section overview

- These are ratios which help equity shareholders and other investors **assess the value and quality of an investment in the ordinary shares of a company**.

Relevant ratios are:

- earnings per share;
- dividend cover;
- price/earnings; and
- dividend yield.

The value of an investment in ordinary shares in a company **listed on a stock exchange** is its market value, and investment ratios are based on information in the company's published financial statements and knowledge of share prices.

5.1 EARNINGS PER SHARE

Earnings per share is the amount of profit before tax for the period that is attributable to each ordinary share. The calculation can become rather complex, but these more complicated aspects are outside the scope of the FAR syllabus. In its simplest form the calculation is:

Formula to learn

$$\text{Earnings per share} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Number of ordinary shares on issue}}$$

where the profit attributable to ordinary shareholders is profit for the year. Earnings per share will rise if profits increase or if there is a reduction in the number of ordinary shares.

5.2 DIVIDEND COVER

Formula to learn

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per (ordinary) share}}$$

This shows the **proportion of profit for the year that is available for distribution to shareholders that has been paid (or proposed) and the proportion retained in the business to finance future growth.** A dividend cover of 2 times would indicate that the company had paid 50 per cent of its distributable profits as dividends, and retained 50 per cent in the business to finance future operations. Retained profits are an important source of funds for most companies, therefore dividends may only be a small proportion of available profits and so the dividend cover may be quite high.

A **significant change** in the dividend cover from one year to the next would be worth looking at closely. For example, if a company's dividend cover were to fall sharply between one year and the next, it could be that its profits had fallen, but the directors wished to pay at least the same amount of dividends as in the previous year, to keep shareholder expectations satisfied.

Example: For Furlong, dividends in 20X8 were $20 000. Since there were 2.1m shares, dividends per share would be 0.95c per share. No dividends were paid in 20X7.

	20X8	20X7
Dividend cover	= 12.8 / 0.95 = 13.5 times	N/A

5.3 PRICE/EARNINGS (P/E) RATIO

Formula to learn

$$\text{The Price/Earnings (P/E)} = \frac{\text{Current share price}}{\text{EPS}}$$

A high P/E ratio indicates strong shareholder **confidence** in the company and its future, for example, in profit growth, and a lower P/E ratio indicates lower confidence.

The P/E ratio of one company can be compared with the P/E ratios of:

- the same company but in previous accounting periods
- other companies in the same business sector
- other companies generally.

5.4 DIVIDEND YIELD

Dividend yield is the return a shareholder is currently expecting on the shares of a company.

Formula to learn

$$\text{Dividend yield} = \frac{\text{Dividend per share for the year}}{\text{Current market value of the share (ex-div)}} \times 100\%$$

- The dividend per share is taken as the dividend for the previous year.
- Ex-div means that the share price does *not* include the right to the most recent dividend.

Shareholders look for **both dividend yield and capital growth**. Dividend yield is therefore an important aspect of a share's performance.

Question 4: Dividend yield

In the year to 30 September 20X8, an advertising agency declares an interim ordinary dividend of 7.4c per share and a final ordinary dividend of 8.6c per share. Assuming an ex-div share price of 315 cents, what is the dividend yield?

(The answer is at the end of the module.)

6 COMPREHENSIVE QUESTION

LO 6.1

The following question is not of the style that you will see in the Financial Accounting and Reporting exam. It does, however, provide excellent practice in calculating relevant ratios and thinking about what they mean.

Question 5: Ratios

The following information has been extracted from the recently published financial statements of DG.

EXTRACTS FROM THE STATEMENTS OF PROFIT OR LOSS TO 30 APRIL

	20X9 $'000	20X8 $'000
Revenue	11 200	9 750
Cost of sales	8 460	6 825
Profit before tax	465	320

	20X9 $'000	20X8 $'000
This is after charging:		
Depreciation	360	280
Loan note interest	80	60
Interest on bank overdraft	15	9
Audit fees	12	10

STATEMENTS OF FINANCIAL POSITION AS AT 30 APRIL

	20X9		20X8	
	$'000	$'000	$'000	$'000
Assets				
Non-current assets		1 850		1 430
Current assets				
Inventory	640		490	
Receivables	1 230		1 080	
Cash	80		120	
		1 950		1 690
Total assets		3 800		3 120
Equity and liabilities				
Equity				
Ordinary share capital	800		800	
Retained earnings	1 310		930	
		2 110		1 730
Non-current liabilities				
10% loan stock		800		600
Current liabilities				
Bank overdraft	110		80	
Payables	750		690	
Taxation	30		20	
		890		790
Total equity and liabilities		3 800		3 120

The following ratios are those calculated for DG, based on its published financial statements for the previous year, and also the latest industry average ratios:

	DG 30 April 20X8	Industry average
ROI (investment = equity and debentures)	16.31%	18.50%
Profit/sales	3.90%	4.73%
Asset turnover	4.18	3.91
Current ratio	2.14	1.90
Quick ratio	1.52	1.27
Gross profit margin	30.00%	35.23%
Accounts receivable collection period	40 days	52 days
Accounts payable payment period	37 days	49 days
Inventory turnover (times)	13.90	18.30
Gearing	25.75%	32.71%

Required

(a) Calculate comparable ratios (to two decimal places where appropriate) for DG for the year ended 30 April 20X9. All calculations must be clearly shown.

(b) Write a report to the board of directors analysing the performance of DG, comparing the results against the previous year and against the industry average.

(The answer is at the end of the module.)

7 LIMITATIONS OF FINANCIAL ANALYSIS

LO 6.2

Section overview

- Financial analysis, be it simple horizontal analysis with another company, trend analysis over time or ratio analysis has a number of limitations. Many of these stem from the limitations of the financial statements themselves.

7.1 LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements are intended to give a fair presentation of the financial performance of an entity over a period and its financial position at the end of that period. The IASB *Conceptual Framework* and the IFRSs are there to ensure this. However, there are a number of reasons why the information in financial statements should not just be taken at its face value.

7.1.1 PROBLEMS OF HISTORICAL COST INFORMATION

Historical cost information is reliable and can be verified, but it becomes less relevant as time goes by. The value shown for assets in the statement of financial position at historical cost may bear no relation whatever to their current value and what it may cost to replace them. The corresponding depreciation charge will also be low, leading to the overstatement of profits in real terms.

This is particularly misleading when attempting to predict future performance or compare results with those of a company with newer or revalued assets. In terms of predicting future performance, it could be that a major asset will need to be replaced in two years time, at vastly more than the carrying amount of the asset currently shown in the statement of financial position. This will then entail much higher depreciation and interest payments (if a loan or lease is used). In addition, overstatement of profit due to the low depreciation charge can lead to too much profit being distributed, increasing the likelihood of new asset purchases having to be financed by loans. This information could not have been obtained just from looking at the financial statements.

In a period of inflation, financial statements based on historic cost are subject to an additional distortion. Sales revenue will be keeping pace with inflation and so will the cost of purchases. However, using the FIFO method of valuing (and to some degree the weighted average method) inventory being used will be valued at the earliest (and therefore cheapest) purchases. This leads to understatement of cost of sales and overstatement of profits.

7.1.2 CREATIVE ACCOUNTING

Listed companies produce their financial statements while watching the stock market closely and, where possible, they like to produce financial statements which show analysts what they are expecting to see. For instance, a steady rise in profits, with no peaks or troughs is reassuring to potential investors. Companies sometimes achieve this by delaying or advancing invoicing or manipulating cut-offs or accruals. Directors who are paid performance bonuses will favour the steady rise (enough to secure the bonus each year, rather than up one year, down the next) while those who hold share options may be aiming for one spectacular set of results just before they sell.

An important aspect of improving the appearance of the statement of financial position is keeping gearing as low as possible. Investors know that interest payments reduce the amount available for distribution and potential lenders will be less willing to lend to a company which is already highly geared.

A number of creative accounting measures are used to try to reduce gearing. Assets can be 'sold' under a sale and leaseback agreement, which is in effect a disguised loan. And if all else fails, a last minute piece of 'window dressing' can be undertaken. For instance, a loan can be repaid just before the year end and taken out again at the beginning of the next year.

7.1.3 THE EFFECT OF RELATED PARTIES

Relationships and transactions with related parties are a normal feature of business. It is common for entities to carry on activities with or through subsidiaries and associates, or occasionally to engage in transactions with directors or their families. The point is that such transactions cannot be assumed to have always been 'at arm's length' or in the best interests of the entity. Transfer pricing can be used to transfer profit from one company to another and inter-company loans and transfers of non-current assets can also be used in the same way.

IAS 24 *Related Party Disclosures* requires companies to disclose details of such transactions, but those which wish to disguise a related party relationship can probably still find complex ways to do it (the Enron scandal revealed the existence of numerous unfavourable related party transactions) and financial statements do not show the unseen effects of such a relationship. For instance, a subsidiary may not have been allowed to tender for a contract in competition with another group company. Its shareholders will never know about such missed opportunities.

7.1.4 SEASONAL TRADING

This is another issue that can distort reported results. Many companies whose trade is seasonal position their year end after their busy period, to minimise time spent on the inventory count. At this point in time, the statement of financial position will show a healthy level of cash and/or receivables and a low level of trade payables, assuming most of them have been paid. Thus the position is reported at the moment when the company is at its most solvent. A statement of financial position drawn up a few months earlier or later, when trade is slack but fixed costs still have to be paid, may give a very different picture.

7.1.5 ASSET ACQUISITIONS

Major asset acquisitions just before the end of an accounting period can also distort results. The statement of financial position will show an increased level of assets and corresponding liabilities (probably a loan or lease payable), but the income which will be earned from utilisation of the asset will not yet have materialised. This will adversely affect the company's return on investment.

7.2 ACCOUNTING POLICIES

Section overview

- The choice of an accounting policy and the effect of its implementation are almost as important as its disclosure. The accounting policies adopted can have a significant impact on the reported results of a company.

7.2.1 THE EFFECT OF CHOICE OF ACCOUNTING POLICIES

A choice is found in a number of areas of accounting, for example, the option to carry non-current assets at historic cost or revalued amount. The choice made may distort the results of ratio analysis. For example, a company which revalues its assets will have higher net assets and therefore lower ROI than a company which does not. Such factors must be taken into account when performing comparative analysis of two companies.

Where accounting standards allow alternative treatment of items in the financial statements, the accounting policy note should declare which policy has been chosen. Being aware of this disclosure helps to ensure that the results of any ratio analysis are meaningful.

7.3 CHANGES IN ACCOUNTING POLICY

The effect of a change of accounting policy is treated as a prior year adjustment according to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This means that the comparative figures are adjusted for the change in accounting policy for comparative purposes and an adjustment is put through retained earnings.

Under **consistency of presentation** in IAS 1 *Presentation of Financial Statements*, any change in policy may only be made if it can be justified on the grounds that the new policy is preferable to the one it replaces because it will give a fairer presentation of the result and of the financial position of a reporting entity.

The problem with this situation is that the directors may be able to **manipulate the results** through change(s) of accounting policies. This would be done to avoid the effect of an old accounting policy or gain the effect of a new one. It is likely to be done in a sensitive period, perhaps when the company's profits are low or the company is about to announce a rights issue. The management will have to convince the auditors that the new policy was much better, but it is not difficult to produce reasons in such cases.

The effect of such a change is very **short-term**. Most analysts and sophisticated users will discount its effect immediately, except to the extent that it will affect any dividend (because of the potential effect on distributable property). It may also help to avoid breaches of banking covenants because of the effect on certain ratios.

Obviously, the accounting policy for any item in the financial statements could only be changed once in quite a long period of time. Auditors would not allow another change, even back to the old policy, unless there was a wholly exceptional reason.

The managers of a company can choose accounting policies **initially** to suit the company or the type of results they want to get. Any changes in accounting policy must be justified, but some managers might try to change accounting policies just to manipulate the results.

7.4 LIMITATIONS OF RATIO ANALYSIS

The consideration of how accounting policies may be used to manipulate company results leads us to some of the limitations of ratio analysis.

The most important ones are the following:

- In a company's first year of trading there will be no comparative figures. So there will be no indication of whether or not a ratio is improving.
- Comparison against industry averages may not be very revealing. A business may be subject to factors which are not common in the industry.
- Ratios based on historic cost accounts are subject to the distortions inherent in historic cost accounting. In particular, undervalued assets will distort ROI and exaggerate gearing.
- Ratios are influenced by the choice of accounting policy. For instance, a company seeking to maintain or increase its ROI may choose not to revalue its assets.
- Financial statements are subject to manipulation and so are the ratios based on them. Creative accounting is undertaken with key ratios in mind.
- Inflation over a period will distort results and ratios. Profit before tax, and therefore ROI, can be inflated where FIFO is applied during an inflationary period.
- No two companies, even operating in the same industry, will have the same financial and business risk profile. For instance, one may have better access to cheap borrowing than the other and so may be able to sustain a higher level of gearing.

7.5 OTHER ISSUES

Are there other issues which should be looked at when assessing an entity's performance? Factors to consider are the following:

- How technologically advanced is it? If it is not using the latest equipment and processes it risks being pushed out of the market at some point or having to undertake a high level of capital expenditure.
- What are its environmental policies? Is it in danger of having to pay for cleanup if the law is tightened? Does it appeal to those seeking 'ethical investment'?
- What is the reputation of its management? If it has attracted good people and kept them, that is a positive indicator.
- What is its mission statement? To what degree does it appear to be fulfilling it?
- What is its reputation as an employer? Do people want to work for this company? What are its labour relations like?
- What is the size of its market? Does it trade in just one or two countries or worldwide?
- How strong is its competition? Is it in danger of a takeover?

You can probably think of other factors that are important. In some cases you can also look at the quality of the product that a company produces.

KEY MODULE POINTS

- Financial analysis requires the financial statements and ratios of a company to be compared, for example, with industry averages.
- Horizontal analysis is a comparison of one company's financial statements with those of another similar company and consideration of the differences.
- Trend analysis is a comparison of the financial statements of one company with those of the previous year or years.
- Ratio analysis is the practice of analysing amounts reported within the financial statements to calculate further values which add to the findings of basic horizontal or trend analysis.
- Ratios can be grouped into four categories: profitability, solvency, liquidity/efficiency, and investor ratios.
- Profitability ratios include return on investment (ROI), return on assets (ROA), return on equity (ROE), profit margins and asset turnover.
- ROI, ROA and ROE show how well investment (capital employed) is used to generate profits and may be used by the shareholders or the Board to assess the performance of management.
- Solvency is the ability of a company to manage its debt burden in the long run.
- Solvency ratios include gearing, assets to equity, debt to total assets and interest cover.
- Liquidity ratios include the quick and current ratios (and represent short-term management of debt).
- Efficiency ratios include receivables' days, inventory days and payables' days.
- The current and quick ratios reveal a company's ability to pay its debts as they fall due (its liquidity). Efficient management of working capital revealed by efficiency ratios will contribute to a healthy liquidity position.
- Investor ratios include earnings per share, dividend cover, price/earnings ratio and dividend yield.
- Financial statements and any analysis of them are affected by the obvious shortcomings of historic cost information and are also subject to manipulation.
- The accounting policies adopted can have a significant impact on the reported results and ratios of a company.

QUICK REVISION QUESTIONS

1 An entity wishes to increase its return on investment (ROI). Which of the following courses of action will help to achieve this in the short term?

A increase sales
B issue ordinary shares
C revalue land and buildings
D increase the level of dividends paid to equity shareholders

2 The following information relates to M at 31 December 20X3:

	$'000
Trade receivables	80
Current asset investments (cash on deposit)	10
Trade payables	75
Bank overdraft	100

The entity has decided to take the following steps to reduce the overdraft.

1. Inventory with a book value of $8000 will be sold at a loss of $2000.
2. Customers will be offered a cash discount of 10 per cent for immediate payment. Customers owing amounts with a total book value of $20 000 are expected to take advantage of this offer.

In return, the entity's bankers have agreed to make a loan of $40 000, which will be used immediately to purchase new machinery. The loan will be repayable in five equal instalments, the first of which falls due on 31 December 20X4.

Assuming that all the above transactions take place on 31 December 20X3, what is the revised quick (acid test) ratio on that date?

A 0.39:1
B 0.44:1
C 0.46:1
D 0.51:1

3 Z has a current ratio of 1.5, a quick ratio of 0.4 and a positive cash balance. If it purchases inventory on credit, what is the effect on these ratios?

	Current ratio	Quick ratio
A	Increase	Increase
B	Decrease	Increase
C	Increase	Decrease
D	Decrease	Decrease

4 KL has the following capital and reserves at 31 December 20X9:

	$'000
Ordinary shares	300
8% irredeemable preference shares	100
Retained earnings	150
	550

KL also had $200 000 10 per cent loan notes on issue throughout the year. Retained profit for the year was $20 000 after paying the preferred dividend and an ordinary dividend of $7500.

What was the return on equity for the year ended 31 December 20X9?

A 5.0 per cent
B 6.1 per cent
C 6.7 per cent
D 9.2 per cent

5 The accounting ratios of ABC are very similar to the average ratios for the industry in which it operates. ABC has an average operating profit margin of 24 per cent and an average asset turnover of 0.9.

This entity is likely to be

A an architect.
B a food retailer.
C a manufacturer.
D an insurance broker.

6 An entity has the following capital structure.

	$'000
Ordinary shares	100 000
10% Redeemable preference shares	50 000
Retained earnings	80 000
	230 000
12% loan notes	100 000
	330 000

What is the gearing ratio?

A 30.3 per cent
B 43.5 per cent
C 45.5 per cent
D 83.3 per cent

7 X's asset turnover is very low compared with that of its main competitor.

What could be the reason for this?

A X has a smaller proportion of productive assets than its competitor.
B X has recruited a number of additional production staff during the year.
C X embarked on a major program of capital investment towards the end of the previous year.
D X carries its non-current assets at historic cost, while its competitor carries them at current value.

8 The following information relates to an entity.

	$'000
Credit sales for the year ended 31 December 20X6	5600
Credit purchases for the year ended 31 December 20X6	4500
Trade receivables at 31 December 20X6	690
Trade payables at 31 December 20X6	250

The entity's cash cycle has been calculated at 105 days.

How much inventory did the entity hold at 31 December 20X6 (to the nearest thousand dollars)?

A $493 000
B $614 000
C $986 000
D $1 227 000

9 Information from the statement of financial position of MNO has been expressed as percentages of total assets less current liabilities:

	%
Land and property	78
Other non-current assets	19
Inventories and work in progress	–
Trade receivables	459
Cash/short-term investments	89
	645
Bank overdraft	(5)
Trade payables	(540)
Total assets less current liabilities	100

In which of the following industries could MNO be operating?

A retailing
B house building
C manufacturing
D insurance broking

10 ST, UV and WX are listed entities operating in the same business sector. At 31 October 20X6, their P/E ratios were reported as follows:

ST	16.2
UV	12.7
WX	8.4

Which **one** of the following statements about these P/E ratios is correct?

The P/E ratios suggest that

A ST has the highest earnings per share of the three entities.
B ST is regarded by the market as the riskiest of the three entities.
C UV represents the safest investment because its P/E lies approximately midway between the other two.
D WX's share price may be relatively lower than that of ST and UV because of an adverse effect such as a profit warning.

ANSWERS TO QUICK REVISION QUESTIONS

1 A An increase in sales will probably lead to an increase in earnings before interest and tax (sometimes called operating profit). There will be no increase in investment (net assets or capital employed).
Issuing ordinary shares (option B) increases net assets and decreases ROI in the short term, although the issue proceeds can be used to generate additional profit and this may help to increase ROI in the longer term. Revaluing land and buildings upwards (option C) decreases ROI, because it increases net assets and reduces profits. Increasing the level of dividends (option D) has no effect on ROI.

2 B Quick ratio: $\frac{70\,000}{159\,000} = 0.44:1$

	$'000
Assets as stated (80 + 10)	90
Less customers taking advantage of discount	(20)
	70
Liabilities as stated (75 + 100)	175
Cash received from sale of inventory (8 – 2)	(6)
Cash received from trade receivables (20 × 90%)	(18)
Current portion of new loan (40 / 5)	8
	159

3 D Example: suppose the entity purchases inventory worth $300 000:

	Current ratio	Quick ratio
Before	$\frac{1500}{1000} = 1.5$	$\frac{400}{1000} = 0.4$
After	$\frac{1800}{1300} = 1.4$	$\frac{400}{1300} = 0.3$

4 B $\frac{\text{Profit available to equity shareholders}}{\text{Shareholders' equity}}$

$\frac{20 + 7.5}{300 + 150} = 6.1\%$

5 C ABC has a relatively high operating profit and a relatively low asset turnover. This suggests that it is capital intensive. A and D would not normally have high levels of non-current assets. B is more likely to have significant non-current assets, but this type of business normally has low operating profit share margins. Therefore, option C is the most likely option.

6 C $\frac{\text{Interest bearing debt}}{\text{Shareholders' equity} + \text{interest bearing debt}} = \frac{100 + 50}{330} = 45.5\%$

7 C D and A are both likely to result in increased sales revenue relative to investment (capital employed) and therefore in increased asset turnover. B is irrelevant.

8 C Receivables collection period $\frac{\text{Trade receivables}}{\text{Sales}} = \frac{690}{5600} \times 365 = 45 \text{ days}$

Payables payment period $\frac{\text{Trade payables}}{\text{Cost of sales}} = \frac{250}{4500} \times 365 = 20 \text{ days}$

If the cash cycle is 105 days, inventories turnover must be 80 days (105 + 20 – 45).

Inventories turnover is $\frac{\text{Inventories}}{\text{Cost of sales}}$ so inventories are $\frac{80}{365} \times 4500 = \$986\,000$

9 D MNO has no inventories, moderate levels of land and property, low levels of other non-current assets and very high trade receivables and trade payables. This suggests that MNO operates in a service industry. An insurance broker is the only one of the four that fits this profile.

10 D The P/E ratio provides indication of market confidence in an entity, not risk therefore both A and C are not correct. The ratio is calculated as price per share/earnings per share and therefore without the share price of each entity it is impossible to decide whether B is correct. D is correct as a low P/E **may** be due to a low share price.

ANSWERS TO MODULE QUESTIONS

1

	20X8	20X7
EBIT	360 245	247 011
Interest payable	18 115	21 909
	= 20 times	= 11 times

Furlong has more than sufficient interest cover. In view of the company's low gearing, this is not too surprising and so we finally obtain a picture of Furlong as a company that does not seem to have a debt problem, in spite of its high (although declining) debt ratio.

2

	20X7	20X6
Current ratio	$\frac{626.8}{599.1} = 1.05$	$\frac{654.4}{642.2} = 1.02$
Quick ratio	$\frac{584.1}{599.1} = 0.97$	$\frac{576.4}{642.2} = 0.90$
Accounts receivable collection period	$\frac{295.2}{2\,176.2} \times 365 = 50$ days	$\frac{335.5}{2\,344.8} \times 365 = 52$ days
Inventory turnover period	$\frac{42.7}{1659.0} \times 365 = 9$ days	$\frac{78.0}{1731.5} \times 365 = 16$ days
Accounts payable payment period	$\frac{190.8}{1623.7} \times 365 = 43$ days	$\frac{188.1}{1726} \times 365 = 40$ days

Since cost of sales = opening inventories plus purchases less closing inventories, purchases = cost of sales less opening inventories plus closing inventories. For 20X7 purchases = 1659 – 78 + 42.7 = 1623.7. For 20X6 purchases = 1731.5 – 83.5 + 78 = 1726.

The company's current ratio is a little lower than average but its quick ratio is better than average and slightly less than the current ratio. This suggests that inventory levels are strictly controlled, which is reinforced by the low inventory turnover period. It would seem that working capital is tightly managed, to avoid the poor liquidity which could be caused by a long receivables collection period and comparatively high payables.

The company in the exercise is a service company and hence it would be expected to have low inventory and a short inventory turnover period. The similarity of receivables collection period and payables payment period means that the company is passing on most of the delay in receiving payment to its suppliers.

3 (a) The cash cycle can be found as follows:

Inventory turnover period: $\frac{\text{Total closing inventory} \times 365}{\text{Cost of goods sold}}$

plus

Accounts receivable collection period: $\frac{\text{Closing trade receivables} \times 365}{\text{Sales}}$

less

Accounts payable payment period: $\frac{\text{Closing trade payables} \times 365}{\text{Purchases}}$

	20X2
Total closing inventory ($)	410 000
Cost of goods sold ($)	750 000
Inventory turnover period	199.5 days
Closing receivables ($)	230 000
Sales ($)	900 000
Receivables collection period	93.3 days
Closing payables ($)	120 000
Purchases ($)	500 000
Payables payment period	(87.6 days)
Length of cash cycle (199.5 + 93.3 – 87.6)	205.2 days

(b) The steps that could be taken to reduce the cash cycle include the following:

(i) Reducing the raw material inventory turnover period.

(ii) Reducing the time taken to produce goods. However, the company must ensure that quality is not sacrificed as a result of speeding up the production process.

(iii) Increasing the period of credit taken from suppliers. The credit period already seems very long – the company is allowed three months' credit by its suppliers, and probably could not be increased. If the credit period is extended then the company may lose discounts for prompt payment.

(iv) Reducing the finished goods inventory turnover period.

(v) Reducing the receivables collection period. The administrative costs of speeding up debt collection and the effect on sales of reducing the credit period allowed must be evaluated. However, the credit period does already seem very long by the standards of most industries. It may be that generous terms have been allowed to secure large contracts and little will be able to be done about this in the short term.

4 The total dividend per share is (7.4 + 8.6) = 16 cents

$$\frac{16}{315} \times 100 = 5.1\%$$

5 (a)

	20X8		20X9		Industry average
ROI	$\frac{320+60}{2330}$	= 16.3%	$\frac{465+80}{2910}$	= 18.7%	18.5%
Profit/sales	$\frac{320+60}{9750}$	= 3.9%	$\frac{465+80}{11\,200}$	= 4.9%	4.7%
Asset turnover	$\frac{9750}{2330}$	= 4.18x	$\frac{11\,200}{2\,910}$	= 3.85x	3.91x
Current ratio	$\frac{1690}{790}$	= 2.14	$\frac{1950}{890}$	= 2.19	1.90
Quick ratio	$\frac{1080+120}{790}$	= 1.52	$\frac{1230+80}{890}$	= 1.47	1.27
Gross profit margin	$\frac{9750-6825}{9750}$	= 30.0%	$\frac{11\,200-8460}{11\,200}$	= 24.5%	35.2%
Accounts receivable collection period	$\frac{1080}{9750} \times 365$	= 40 days	$\frac{1230}{11\,200} \times 365$	= 40 days	52 days

	20X8		20X9		Industry average
Accounts payable payment period *	$\frac{690}{6825} \times 365$	= 37 days	$\frac{750}{8610} \times 365$	= 32 days	49 days
Inventory turnover (times)	$\frac{6825}{490}$	= 13.9x	$\frac{8460}{640}$	= 13.2x	18.30x
Gearing	$\frac{600}{2330}$	= 25.8%	$\frac{800}{2910}$	= 27.5%	32.7%

* For 20X9 purchases are calculated as (8460 + (640 – 490)). The 20X8 ratio uses cost of sales as we are unable to calculate the movement in inventory between 20X7 and 20X8.

(b) (i) REPORT

To: Board of Directors
From: Accountant Date: xx/xx/xx
Subject: Analysis of performance of DG

This report should be read in conjunction with the appendix attached which shows the relevant ratios (from part (a)).

Trading and profitability

Return on investment (return on capital employed) has improved considerably between 20X8 and 20X9 and is now higher than the industry average.

Profit after tax as a proportion of sales has also improved noticeably between the years and is also now marginally ahead of the industry average. Gross margin, however, is considerably lower than in the previous year and is only some 70 per cent of the industry average. This suggests either that there has been a change in the cost structure of DG or that there has been a change in the method of cost allocation between the periods. Either way, this is a marked change that requires investigation. The company may be in a period of transition as sales have increased by nearly 15 per cent over the year and it would appear that new non-current assets have been purchased.

Asset turnover has declined between the periods although the 20X9 figure is in line with the industry average. This reduction might indicate that the efficiency with which assets are used has deteriorated or it might indicate that the assets acquired in 20X9 have not yet fully contributed to the business. A longer term trend would clarify the picture.

(ii) **Liquidity and working capital management**

The current ratio has improved slightly over the year and is marginally higher than the industry average. It is also in line with what is generally regarded as satisfactory (2:1).

The quick ratio has declined marginally but is still better than the industry average. This suggests that DG has no short-term liquidity problems and should have no difficulty in paying its debts as they become due.

Receivables as a proportion of sales is unchanged from 20X8 and are considerably lower than the industry average. Consequently, there is probably little opportunity to reduce this further and there may be pressure in the future from customers to increase the period of credit given. The period of credit taken from suppliers has fallen from 37 days' purchases to 32 days' and is much lower than the industry average; thus, it may be possible to finance any additional receivables by negotiating better credit terms from suppliers.

Inventory turnover has fallen slightly and is much slower than the industry average and this may partly reflect stocking up ahead of a significant increase in sales. Alternatively, there is some danger that the inventory could contain certain obsolete items that may require writing off. The relative increase in the level of inventory has been financed by an increased overdraft which may reduce if the inventory levels can be brought down.

The high levels of inventory, overdraft and receivables compared to that of payables suggests a labour intensive company or one where considerable value is added to bought-in products.

(iii) Gearing

The level of gearing has increased only slightly over the year and is below the industry average. Since the return on investment is nearly twice the rate of interest on the loan stock, profitability is likely to be increased by a modest increase in the level of gearing.

Signed: Accountant

REVISION QUESTIONS

MODULE 1

1 Which of the following are correct?
   I. The term 'reporting entity' may be used to describe a group of companies.
   II. The principal function of financial statements is to provide information to parties external to a business.
   III. The main purpose of financial reporting is to provide information aimed at running a business more efficiently.

   A I and II only
   B I and III only
   C II and III only
   D I, II and III

2 Which of the following groups of users of accounts is interested primarily in the liquidity of a company?
   A suppliers
   B the government
   C the management
   D the tax authorities

3 Consider the following two statements:
   I. The IASB operates a rules-based system of setting accounting standards.
   II. The US FASB operates a principles-based system of setting accounting standards.

   Which of these statements are correct?
   A I only
   B II only
   C both I and II
   D neither I nor II

4 Which bodies does the IFRS Foundation oversee?
   A IASB and the Monitoring Board
   B IASB and IFRS Interpretations Committee only
   C IFRS Interpretations Committee and IFRS Advisory Council
   D IFRS Advisory Council, IASB and IFRS Interpretations Committee

5 Which of the following is **not** a role of the IFRS Advisory Council?
   A to consult on all major IASB projects
   B to issue International Financial Reporting Standards
   C to advise on the prioritisation of the work of the IASB
   D to comment on the implications of the work of the IASB on users of financial statements

6 Consider the following two statements:
   I. The Australian Accounting Standards Board (AASB) has adopted the content of IFRS with some minor changes.
   II. Both Australian companies' legislation and IFRS allow an entity to depart from the requirements of an IFRS in exceptional circumstances.

   Which of these statements are correct?
   A I only
   B II only
   C both I and II
   D neither I nor II

7 According to the *Conceptual Framework for Financial Reporting*, information about an entity's financial performance helps users to understand

I. the entity's needs for additional finance.
II. the entity's financing and investing activities.
III. the efficiency and effectiveness of management.
IV. the return that the entity has produced on its economic resources.

A IV only
B III and IV only
C I and III only
D I and II only

8 Which of the following is **not** a chapter in the IASB's *Conceptual Framework*?

A underlying assumption
B concepts and conventions
C the elements of financial statements
D recognition of the elements of financial statements

9 Consider the following statements:

I. One of the purposes of the IASB's *Conceptual Framework* is to allow alternative accounting treatments in accounting standards.
II. One of the purposes of the IASB's *Conceptual Framework* is to assist auditors in forming an opinion as to whether financial statements have complied with IFRS.

Which of the statements is correct?

A I only
B II only
C both I and II
D neither I nor II

10 What is shown by an entity's economic resources and the claims against it?

A its operations
B its financial position
C its ownership interest
D its financial performance

11 Why is information about a reporting entity's net cash flows helpful to users?

A It helps them to predict future cash flows.
B It helps them to assess the stewardship of management.
C It helps them to understand the claims against the entity.
D It helps them to understand the entity's financial performance.

12 Which of the following statements is/are correct?

I. An entity can only change an accounting policy if this is required by an accounting standard.
II. A change in accounting policy is always applied prospectively, so that the effect of the change is recognised in the current period.

A I only
B II only
C I and II
D neither I nor II

13 The underlying assumption in preparing and using general purpose financial reports is

A accruals.
B materiality.
C going concern.
D substance over form.

14 Consider the following statements:

I. Accounting standards are not retrospective.

II. Accounting standards are applied to all items in the financial statements.

Which statements are correct?

A I only
B II only
C both I and II
D neither I nor II

15 The two fundamental qualitative characteristics of useful financial information are:

A relevance and verifiability.
B verifiability and timeliness.
C faithful representation and relevance.
D faithful representation and timeliness.

16 Which of the following qualities are required to achieve a faithful representation of economic phenomena?

I. error free
II. neutrality
III. verifiability
IV. comparability
V. completeness

A I, II and III only
B I, II and V only
C I, III and V only
D II, IV and V only

17 Which of the following statements is/are correct?

I. Departure from an IFRS is allowed only where approved by the IASB.

II. In the case of a true and fair override the financial impact of the departure from IFRS should be disclosed.

A I only
B II only
C I and II
D neither I nor II

18 Which of the following is the correct definition of equity?

A the residual interest in the assets of the entity after deducting all its liabilities
B a present obligation arising from past events from which future economic benefits are expected to flow to the entity
C a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity
D a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits

19 Consider the following statements:

I. A provision is a liability for which the amount is an estimate.

II. A provision should not be recognised in the financial statements.

Which of the statements are correct?

A I only
B II only
C both I and II
D neither I nor II

20 Consider the following statements:

I. Gains from revaluation of non-current assets are recognised in profit or loss.

II. Gains from the sale of non-current assets are not recognised in profit or loss.

Which of the statements are correct?

A I only
B II only
C both statements
D neither statement

21 Which of the following, taken together, would make up the working capital of a business?

A inventory, equity, cash at bank, receivables
B receivables, bank loan, payables, inventory
C payables, receivables, inventory, cash at bank
D inventory, bank loan, cash at bank, prepayments

22 Which of the following would appear in the statement of financial position as a current liability?

A sales tax owing
B employee wages paid
C prepayments of expenses
D revaluation surplus on a non-current asset

23 Which one of the following should be recognised as an asset in the statement of financial position according to the definition of an asset and recognition criteria provided in the *Conceptual Framework?*

A a football player acquired on a contract for a transfer fee
B an amount spent on investigating the healing powers of an Amazonian plant
C an amount spent on training staff which is expected to result in increased productivity
D an amount spent on advertising that is expected to result in increased sales for the next three years

MODULE 2

1 What type of cost does the following definition describe?

'Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.'

A current cost
B present value
C historical cost
D realisable value

2 What is one of the main advantages of using historical cost as a measurement basis?

A It is objective.
B It is subjective.
C It is a reasonable estimate.
D It can use a formula for calculation.

3 Which of the following does this definition describe?

'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'.

A fair value
B current value
C residual value
D economic value

4 Consider the following statements:

I. The use of a conceptual framework and accounting standards based on that framework would be an example of positive accounting theory.
II. An attempt to predict accounting behaviour by observing what actually happens and applying this to particular situations is an example of normative accounting theory.

Which statements are correct?

A I only
B II only
C both I and II
D neither I nor II

5 Which type of capital maintenance concept is described by the following statement?

'Capital is looked at as the capacity to maintain a level of assets'.

A equity capital maintenance
B financial capital maintenance
C operating capital maintenance
D proprietary capital maintenance

6 Consider the following statements:

I. In a time of rising prices, borrowers benefit.
II. Under current purchasing power (CPP) accounting, monetary items are restated to take into account the effect of general price inflation.

Are these statements correct or not correct?

	Statement I	Statement II
A	correct	correct
B	not correct	correct
C	correct	not correct
D	not correct	not correct

7 Consider the following statements:
   I. A management buy-in occurs when existing managers purchase the business.
   II. In a share option scheme, employees are given a number of share options, each of which gives the holder the right after a certain date to subscribe for shares in the company at a fixed price.

   Which of the statements are correct?

   A I only
   B II only
   C both I and II
   D neither I nor II

8 The preparation of the financial statements is the responsibility of
   A the Finance Director.
   B the external auditors.
   C the Board of Directors.
   D the internal audit department.

9 Consider the following statements:
   I. The auditor's report must be disclosed in a set of financial statements.
   II. The auditors' report confirms that the financial statements are correct.

   A I only
   B II only
   C both I and II
   D neither I nor II

10 Which of the following is a non-mandatory disclosure in a listed company's annual report?
   A statement of cash flows
   B statement of financial position
   C social and environment report
   D corporate governance disclosures

11 Which of the following is **not** an advantage of voluntary disclosures by companies?
   A it can be focused on future strategies and objectives
   B provision of additional information to other companies in the same business
   C provides investors with further yardsticks to judge the performance of management
   D gives shareholders a better idea of the environment within which the company is operating and how it is responding to that environment

12 Which of the following statements about the directors' report are correct?
   I. It includes details of the individual directors on the board.
   II. It includes a review of the entity's operations during the period.
   III. It shows the members of the board who sit on the various committees, such as audit, remuneration and nomination committees.

   A I and II only
   B I and III only
   C II and III only
   D I, II and III

MODULE 3

1 Where in a company's financial statements are dividends paid found?
   A the statement of financial position
   B the statement of changes in equity
   C the statement of profit or loss and other comprehensive income
   D the statement of profit or loss and the statement of changes in equity

2 Classify the following amounts as current or non-current:
   I. a bank overdraft expected to be in place for two years
   II. shares bought in another company for the purpose of resale in the near future
   III. a receivable arising from a credit sale made to a customer with payment terms of 24 months

	Current	Non-current
A	I	II and III
B	II	I and III
C	I and III	II
D	I, II and III	none

3 Which of the following must be shown in the main financial statements of a typical manufacturing company rather than in the notes to the financial statements?
   A a classification of expenses
   B the number of shares in issue
   C the classes of property, plant and equipment
   D the classification of assets as current and non-current

4 A statement of cash flows prepared in accordance with the indirect method reconciles profit before tax to cash generated from operations. Which of the following includes only items which should be added to profit before tax in the reconciliation?
   A depreciation charge, investment income and increase in inventories
   B increase in payables, loss on disposal of non-current assets and depreciation
   C decrease in receivables, finance cost and profit on disposal of non-current assets
   D decrease in payables, depreciation charge and loss on disposal of non-current assets

5 A company made a profit for the year of $12 990 after accounting for depreciation of $1300. During the year, non-current assets were purchased for $6500, receivables increased by $560, inventories decreased by $1100 and payables increased by $230.
   The increase in cash and bank balances during the year was
   A $530
   B $4420
   C $7020
   D $8560

6 A business had non-current assets with a carrying amount of $90 000 at the start of the financial year. During the year the business sold machinery that had cost $12 000 and been depreciated to a carrying amount of $3400. The carrying amount of non-current assets at the end of the year was $91 500. How much cash has been used to purchase non-current assets?
   A $1900
   B $4900
   C $10 500
   D $13 500

7 A business' bank balance increased by $960 000 during its last financial year. In this period, it

- issued shares raising $1 400 000
- repaid a loan of $230 000
- purchased current asset investments of $800 000
- charged depreciation of $190 000

Working capital increased by $120 000 during the year.

The business' profit for the year was

A $280 000
B $520 000
C $660 000
D $1 400 000

8 Extracts from a company's statement of financial position showed balances as follows:

	20X9	20X8
	$	$
Share capital	94 000	77 000

During 20X9 debentures of $70 000 were issued, a dividend of $12 000 was received and interest of $4000 was paid.

What is the net cash flow from financing activities?

A $17 000 inflow
B $87 000 inflow
C $95 000 inflow
D $99 000 inflow

9 What type of assurance is provided by the external auditor's report on an entity's financial statements?

A limited
B absolute
C negative
D reasonable

MODULE 4

1 Which of the following conditions must be met, in order to capitalise development costs according to IAS 38?

I. completion of the asset is technically feasible
II. resources are available to complete the project
III. there is a contract to sell or written commitment to use the item under development

A I only
B I and II only
C II and III only
D I, II and III

2 Which of the following statements about intangible assets is correct?

A Goodwill can never be revalued.
B An intangible asset must be separable.
C Development costs may be capitalised if the criteria laid down in IAS 38 are met.
D An intangible asset may be revalued where a fair value can be established through use of an expert valuer.

3 An entity purchases a specialised machine on 1 January 20X8 for $400 000 together with production rights to manufacture a patented component, for $20 000. These production rights are worthless without the specialised machine, and the machine may not be used without the production rights.

Which of the following statements is correct?

A $420 000 is capitalised as an intangible asset.
B $420 000 is capitalised as a tangible non-current asset.
C $400 000 is capitalised as a tangible non-current asset and $20 000 as an intangible asset.
D $400 000 is capitalised as a tangible non-current asset and $20 000 is expensed in the period.

4 An entity purchases the brand name of a product on 1 November 20X8 for $375 000. The management feel that the brand has an indefinite useful life and have therefore not charged any amortisation in the year ended 31 October 20X9.

Which of the following is correct?

A Amortisation should be charged based on an assumed maximum useful life of 20 years.
B Amortisation should be charged based on an assumed maximum useful life of 50 years.
C There is no requirement to charge amortisation, however the brand must be tested for impairment when indications of an impairment arise.
D There is no requirement to charge amortisation, however the brand must be tested for impairment each year and in addition, whenever there are indications of an impairment.

5 The following is relevant to ABC Co. in the year ended 31 December 20X9:

- $28 000 was spent investigating the properties of a new type of plastic.
- $340 000 was capitalised relating to the development of a new product which went into commercial production on 1 October 20X9. Sales of the product are expected to remain constant for the first four years of its production and then halve for a further two years.

What amounts should be recognised in the financial statements of ABC Co. in the year ended 31 December 20X9?

	Statement of profit or loss and other comprehensive income	Statement of financial position
A	$17 000	$351 000
B	$28 000	$340 000
C	$36 500	$331 500
D	$45 000	$323 000

6 At the current year end, Claxon Co. has undertaken impairment tests on two machines. The following information is relevant:

	Machine 1	Machine 2
Cost	$450 000	$250 000
Useful life	10 years	15 years
Age	4 years	3 years
Fair value	$300 000	$230 000
Costs of disposal	$15 000	$35 000
Value in use	$260 000	$198 000

At what carrying amount should machinery be recognised in the accounts of Claxon Co?

A $455 000
B $468 000
C $470 000
D $498 000

7 Taunton Co. owns a property which was revalued to $900 000 at the start of the current accounting year. At that time the property had a remaining useful life of 25 years. As a result of market conditions, an impairment test is carried out at the end of the year and the property is found to have a value in use of $860 000 and a fair value of $870 000. Costs of disposal would amount to 5 per cent of fair value.

What impairment loss, if any, must be recorded in the year?

A $nil
B $4000
C $37 500
D $40 000

8 Which of the following statements is/are correct?

I. An impairment loss relating to goodwill cannot be reversed.
II. Corporate assets must always be allocated to individual CGUs.
III. An impairment loss relating to a CGU is allocated to goodwill in the first instance.

A I only
B II and III only
C I, II and III
D none of them

9 Anton Co. has identified a cash generating unit made up of the following assets:

	Carrying amount $
Property	200 000
Machinery	50 000
Goodwill	25 000
Receivables	15 000
Inventory	10 000

An impairment loss of $55 000 has been identified. What is the carrying amount of the machinery after this loss has been accounted for?

A $39 000
B $42 727
C $43 333
D $44 000

10 Rawlin Co. purchased a depreciable asset a number of years ago at a cost of $200 000. On 1 January 20X8, when it had 20 years of its useful life remaining, the asset was revalued to $600 000, with a revaluation surplus of $480 000 recognised as other comprehensive income. At 31 December 20X9, the value in use of the asset is $535 000 and its fair value less costs of disposal is $532 000. What impairment loss must be recognised and where?

	Loss	Recognised in
A	$5 000	Profit or loss
B	$5 000	Other comprehensive income
C	$35 000	Other comprehensive income
D	$65 000	Other comprehensive income

11 Which of the following are conditions that permit revenue to be recognised over a period of time?

I. The customer has paid in advance.
II. The customer simultaneously receives and consumes the benefits as the performance takes place.
III. The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

A I only
B I and II only
C II and III only
D I, II and III

12 Details of two of Lord Company's transactions in the month of May are as follows:

I. It has sold goods to another customer on credit. The goods have not yet been delivered.
II. It has sold an item of machinery to a customer; the machinery has been delivered and Lord Company will undertake specialist installation in two months' time.

For which transactions should revenue be recognised in May?

A I only
B II only
C both I and II
D neither I nor II

13 Bubble Co. made sales on credit during May 20X7 of $450 000 for goods that were all delivered during May. Sales tax is charged at 5 per cent. They offer all customers a settlement discount of 5 per cent and on average 40 per cent of customers will take up the discount.

What is Bubble Co. revenue for May 20X7?

A $441 000
B $450 000
C $463 050
D $472 500

14 Ray Co. reported the following amounts in its statement of financial position at 31 December 20X8:

Liability for company taxes	$43 800
Liability for deferred tax	$79 320

The 20X8 tax liability was eventually settled at $42 120.

At the 20X9 year end, there is a liability for current tax of $52 300 and the total liability for deferred tax is to decrease to $69 780. The decrease in deferred tax liability relates to items recognised within profit or loss.

What is Ray Co.'s tax charge for 20X9?

A $41 080
B $44 440
C $60 160
D $63 520

15 The following information is relevant to Drive Co.'s non-current assets at 31 October 20X8 and 20X9:

	20X9	20X8
Cost	$765 400	$697 600
Accumulated depreciation	$239 140	$202 300
Accumulated capital allowances	$347 800	$278 000

Drive Co. pays corporate income tax at a rate of 20 per cent.

What is Drive Co.'s deferred tax liability at 31 October 20X9, and deferred tax charge for the year ended 31 October 20X9?

	Tax liability	Tax charge
	$	$
A	15 140	15 140
B	21 732	6 592
C	21 732	21 732
D	108 660	32 960

16 Which of the following statements about IAS 12 is/are correct?

I. Deferred tax liabilities may be classified as current liabilities.
II. Tax losses are an example of a taxable temporary difference.
III. Deferred tax relating to the revaluation of a property is reported as other comprehensive income.

A II only
B I and II only
C I and III only
D II and III only

17 Wiley Co. has made tax trading losses for two years, totalling $87 600. $23 000 of these were used to relieve other taxable income in accordance with tax law. At the 31 December 20X9 year end, Wiley Co. signs a large contract with a new customer which indicates that it will return to profitability. Wiley Co.'s tax rate is 20 per cent. What is the deferred tax implication of the losses?

A a deductible temporary difference of $64 600 arises and a deferred tax asset of $12 920 is recognised at 31 December 20X9

B a taxable temporary difference of $64 600 arises and a deferred tax liability of $12 920 is recognised at 31 December 20X9

C a taxable temporary difference of $87 600 arises and a deferred tax liability of $17 520 is recognised at 31 December 20X9

D a deductible temporary difference of $87 600 arises and a deferred tax asset of $17 520 is recognised at 31 December 20X9

18 The trial balance of Vine Co. at 31 December 20X8 shows a credit balance on the tax payable account of $450. The estimated current tax liability of $28 760 has not yet been accrued.
What amounts are reported in the financial statements in respect of current tax for the year?

	Tax liability	Tax charge
	$	$
A	28 310	28 310
B	28 760	28 310
C	28 760	29 210
D	29 210	29 210

19 Radley Co. purchased raw materials on credit from a foreign supplier for 375 000 Goldings, halfway through the year ended 31 December 20X9. Half of the goods were paid for on 30 November 20X9 and the remaining half on 31 January 20Y0.

Relevant exchange rates are as follows:

30 June 20X9	4.3 G: $1
30 November 20X9	4.6 G: $1
31 December 20X9	4.5 G: $1
31 January 20Y0	5 G: $1

What exchange difference is recognised in Radley Co.'s profit or loss in the year ended 31 December 20X9?

A $2844 loss

B $2844 gain

C $4782 loss

D $4782 gain

20 The abbreviated functional currency statement of financial position at 30 November 20X9 of Pedro Co., a subsidiary of Aus Co., bought at the start of the year is as follows:

	Euro
Assets	560 000
Share capital	100 000
Retained earnings b/f	220 000
Profit for the year	70 000
Liabilities	170 000
	560 000

Pedro Co. was incorporated on 1 January 20X5.

Relevant exchange rates are as follows:

30 November 20X9	$1: euro 0.8
1 December 20X8	$1: euro 0.75
1 January 20X5	$1: euro 0.95
Average for y/e 30 November 20X9	$1: euro 0.77

To the nearest $000 what are the translated retained earnings (including exchange differences) of Pedro Co. at 30 November 20X9?

A $354 000
B $362 000
C $366 000
D $382 000

21 Flurry Co. prepares its financial statements in its functional currency, the Durham, translating to dollars in order to report to its parent company.

The following information is relevant:

	Net assets (D)	Exchange rate
1 January 20X9	650 000	4.3D/$
31 December 20X9	780 000	4D/$

The retained profits for the year were D115 000 and the average exchange rate was 4.2D/$.

What exchange difference arises on translation of the financial statements?

A $11 337 loss
B $11 337 gain
C $12 706 loss
D $12 706 gain

22 Drayton Co. purchased a new non-current asset on 1 January 20X9 costing HK$ 1 450 000, agreeing 18 months' extended credit with the supplier.

The exchange rate on 1 January 20X9 was 6.75HK$:$1. At 31 December 20X9, the exchange rate had moved to 7.2HK$:$1.

How are the asset and payable presented in the statement of financial position at 31 December 20X9?

	Asset	Payable
A	$201 389	$201 389
B	$201 389	$214 815
C	$214 815	$201 389
D	$214 815	$214 815

23 Which of the following statements is or are correct?

I. Exchange differences are always reported in profit or loss.
II. The currency that mainly influences sales prices set by an entity is likely to be the functional currency.
III. A revalued 'foreign' asset is translated at the exchange rate in force on the date of the revaluation.

A I and II only
B I and III only
C II and III only
D I, II and III

24 On 1 January 20X5 Cornwall Company entered into a four year lease for new computer equipment. A non-refundable deposit of $2000 was paid on this date. The first lease payment of $8000 will be made on 1 January 20X6 with two further payments of $8000 being paid on 1 January 20X7 and 20X8.

Cornwall Company elected to treat the lease as a low value lease.

What expense will be shown in the profit or loss for the year ended 31 December 20X5?

A $2000
B $6000
C $6500
D $8000

25 On 1 January 20X5 Kent Company enters into a three year lease for an asset, paying an initial deposit of $18 000. The present value of the future cash flows is $150 000. The asset they are leasing has a useful life of five years and Kent Company will not obtain ownership at the end of the lease.

What is the depreciation expense for the right of use asset for the year ended 31 December 20X5?

A $33 600
B $44 000
C $50 000
D $56 000

MODULE 5

1 Raleigh Co. holds the following investments:

- 30 per cent of the voting shares in Well Co. The remaining 70 per cent are held by a third, unrelated, company, Slim Co., which refuses to communicate with Raleigh Co.
- 18 per cent of the voting shares in Vic Co. One of Raleigh's Directors also sits on the Board of Vic Co. and takes an active part in formulating strategy.

How should the investments be accounted for?

	Well Co.	Vic Co.
A	associate	associate
B	investment	associate
C	associate	investment
D	investment	investment

2 Dry Co. holds 20 per cent of the voting shares in Wet Co. and has agreed with the other shareholders that it will direct the operating activities of that company. Dry Co. also holds 40 per cent of the voting shares in Cloud Co., participating in the policy making process of that company, and 25 per cent of the voting shares in Drizzle Co.

How should these investments be treated in the Dry Co. group accounts?

	Wet Co.	Cloud Co.	Drizzle Co.
A	Consolidated	Consolidated	Held at cost
B	Equity accounted	Equity accounted	Held at cost
C	Consolidated	Equity accounted	Equity accounted
D	Equity accounted	Consolidated	Equity accounted

3 Which of the following conditions must be met in order for a parent to avoid presenting consolidated financial statements?

I. All subsidiaries operate under severe long-term restrictions.
II. Its securities are not publicly traded and it is not in the process of issuing securities in public securities markets.
III. The ultimate or intermediate parent publishes consolidated financial statements that comply with International Financial Reporting Standards.
IV. The parent is itself a wholly-owned subsidiary or it is a partially-owned subsidiary of another entity and its other owners do not object to the parent not presenting consolidated financial statements.

A I, II and III only
B I, III and IV only
C II, III and IV only
D I, II, III and IV

4 Which of the following statements about consolidated financial statements is correct?

A IAS 28 states that investments should be held in the investor's individual accounts using the equity method.
B IFRS 10 allows subsidiaries to be excluded from consolidation if their activities are dissimilar from those of the parent.
C Where a subsidiary uses different accounting policies from its parent company, this must be disclosed in the group accounts.
D An investor cannot control another company if it does not have the ability to use its power over the investee to affect the amount of the investor's returns.

5 Which of the following provides evidence of the existence of significant influence?

A material transactions between investor and investee

B power to govern the financial and operating policies of the entity

C agreement with other shareholders of the entity to vote on their behalf

D power to appoint or remove a majority of members of the board of directors

6 Train Co. owns 80 per cent of Car Co. Extracts from the companies' statements of financial position are as follows:

	Train Co. $'000	Car Co. $'000
Receivables	91	67
Cash	23	–
Payables	87	53
Overdraft	–	9

Included within the receivables of Car Co. is $7000 due from Train Co. Included within the payables of Train Co. is $5600 due to Car Co. The difference is due to cash in transit.

What are the consolidated receivables and cash balances?

	Receivables	Cash
A	$151 000	$23 000
B	$151 000	$24 400
C	$152 400	$23 000
D	$152 400	$24 400

7 West Co. acquired 90 per cent of the 100 000 shares in East Co. on 1 January 20X7 for $480 000 when the reserves of that company amounted to $320 000. On that date the fair value of the non-controlling interest was valued at $45 000. Included in East Co.'s statement of financial position was land with a book value of $60 000. The fair value was $30 000 higher than this. West Co. group measures the non-controlling interest at fair value.

What goodwill arose on the acquisition of East Co.?

A $75 000

B $102 000

C $105 000

D $135 000

8 North Co. acquired 80 per cent of South Co. on 1 February 20X8 for consideration totalling $560 000. At this date the fair value of a 20 per cent holding in South Co. was $130 000, and the net assets of South Co. were $620 000. In the year ended 31 January 20X9, South Co. reported profits of $75 000. North Co. group measures the non-controlling interest using the proportion of net assets method. What is the non-controlling interest to be reported in the consolidated statement of financial position at 31 January 20X9?

A $137 750

B $139 000

C $143 750

D $145 000

9 Axis Co. transferred an asset to its 75 per cent subsidiary Yves Co. on 31 October 20X9 for $25 000. The asset cost $32 000 on 1 November 20X7 and was depreciated monthly by Axis Co. at 20 per cent per annum on cost. Yves Co. did not amend the original useful life on the transfer and continued to depreciate the asset over its remaining life. At 31 December 20X9, extracts from the two companies' accounts were as follows:

	Axis Co. $	Yves Co. $
Non-current assets	165 000	180 000

What is the consolidated figure for non-current assets?

A $339 200
B $339 522
C $343 522
D $345 000

10 Try Co. bought 80 per cent of the ordinary shares in Ply Co. when the retained earnings of that company were $400 000. Goodwill arising on acquisition amounted to $68 000, and 25 per cent of this amount was written off in the year ended 31 October 20X7.

During the year ended 31 October 20X9, Try Co. sold $50 000 goods to Ply Co., achieving a 20 per cent mark up. At the year end, Ply Co. retained half of these in inventory.

The two companies' retained earnings at 31 October 20X9 were as follows:

Try Co.	$680 900
Ply Co.	$532 000

What are group retained earnings at 31 October 20X9?

A $553 300
B $765 333
C $782 333
D $1 085 333

11 P Co. acquired 80 per cent of the ordinary share capital in S Co. on 31 August 20X9. Extracts from the two companies' statements of profit or loss for the year ended 31 October 20X9 were as follows:

	P Co. $'000	S Co. $'000
Revenue	2 900	1 800
Cost of sales	1 500	900

During the year, P Co. made sales of $10 000 to S Co. each month, realising a mark up of 25 per cent. At the end of the year S Co. had none of these goods in inventory.

What is the group gross profit for the year ended 31 October 20X9?

A $1 546 000
B $1 550 000
C $1 625 000
D $2 300 000

12 Ed Co. has owned 100 per cent of the shares in Clem Co. for five years. These were bought for $450 000 when the net assets of Clem Co. were $415 000. In the year of acquisition, Clem Co. was impaired by $5000 due to a drop in profitability. Clem Co. has again suffered a loss of profits in the year ended 31 December 20X9, and accordingly goodwill is to be impaired by 20 per cent of book value. Extracts from the two companies' statements of profit or loss are as follows:

	Ed Co.	Clem Co.
	$	$
Cost of sales	320 000	126 000
Administrative expenses	100 000	36 000

What are the amounts to be reported for group cost of sales and administrative expenses?

	Cost of sales	Administrative expenses
	$	$
A	439 000	136 000
B	440 000	136 000
C	446 000	129 000
D	446 000	142 000

13 Black Co. sold an item of machinery to Red Co., its subsidiary on 31 December 20X8 for $340 000. The machine had cost Black Co. $400 000 and had a carrying amount of $320 000 on the date of the transfer, based on annual depreciation at 10 per cent on the straight line basis. The remaining useful life of the asset remains unchanged. Companies in the Black Co. Group depreciate any asset held on the last day of the accounting period for a full year. Depreciation is charged to cost of sales.

What adjustment is required to the Black Co. cost of sales in respect of this transfer in the year ended 31 December 20X9?

A a decrease of $22 500
B a decrease of $2500
C an increase of $2500
D an increase of $17 500

14 Green Co. sold an item of plant to Brown Co., its subsidiary on 31 October 20X9 for $200 000. The machine had cost Green Co. $300 000 and had a carrying amount of $220 000 on the date of the transfer, based on a useful life of 15 years on the straight line basis. The remaining useful life of the asset remains unchanged. Green Co. depreciates assets on a monthly basis.

What adjustment is required to Green Co.'s profit in respect of this transfer in the year ended 31 December 20X9?

A $18 182 to add back to profit
B $19 697 to add back to profit
C $20 303 to add back to profit
D $20 303 to deduct from profit

15 Which of the following statements about the consolidated statement of profit or loss are correct?

I. Dividend income in the parent company's statement of profit or loss is never carried across to the consolidated statement of profit or loss.
II. The non-controlling interest in profit is presented separately from group profits in the consolidated statement of profit or loss to leave profit allocated to the owners of the parent company.

A I only
B II only
C both I and II
D neither I nor II

16 Roulston Co. holds a 75 per cent investment in Hudson Co. and a 35 per cent investment in White Co. During the year ended 30 November 20X9, Roulston Co. sold goods to Hudson Co. for $400 000 and White Co. sold goods to Roulston Co. for $210 000. The companies' revenue as reported in their individual financial statements was as follows:

	$'000
Roulston Co.	1490
Hudson Co.	430
White Co.	1200

What is the consolidated revenue figure?

A $1 383 500
B $1 520 000
C $2 510 000
D $2 583 000

17 Dray Co. holds a 90 per cent investment in Ray Co. and a 25 per cent investment in Lay Co. Extracts from their statements of profit or loss are as follows:

	Dray Co. $	Ray Co. $	Lay Co. $
Revenue	136 500	127 800	67 000
Cost of sales	86 500	73 400	24 000

During the year Dray Co. sold $40 000 goods to Ray Co. and $10 000 to Lay Co. at a 25 per cent mark up. In each case all of these goods remained in inventory at the year end.

What is the consolidated cost of sales figure?

A $109 900
B $111 900
C $127 900
D $128 400

18 Blue Co. has a number of subsidiaries as well as a 45 per cent investment in Pink Co. bought for $190 000 some years ago. Since acquisition, Pink Co. has made $450 000 profits and suffered no impairment. During the year ended 31 October 20X9, Pink Co. sold $30 000 goods to Blue Co. at a 20 per cent margin. Half of these goods remained in Blue Co.'s warehouse at the year end.

What is the investment in associate shown in the Blue Co. Group statement of financial position at 31 October 20X9?

A $386 500
B $389 500
C $391 150
D $392 500

19 Which of the following statements about equity accounting and associates is correct?

A The tax charge relating to an associate must be separately disclosed in the consolidated statement of profit or loss.
B Any impairment of an associate is charged to administrative expenses in the consolidated statement of profit or loss.
C There is no requirement for an associate to be consolidated or equity accounted using the same accounting policies as those adopted by the group.
D Where an associate is loss making, the investor should discontinue including its share of losses when the investor's share of losses of the associate equals or exceeds its interest in the associate.

20 Arm Co. Group bought 16 per cent of the voting shares in Leg Co. on 1 January 20X9 for $160 000, and on the same date started trading with Leg Co. such that 80 per cent of Leg Co.'s sales were made to Arm Co. In the year ended 31 December 20X9, Leg Co. made $98 000 profits, 80 per cent of these relating to sales to Arm Co. None of the goods purchased from Leg Co. remained in the inventory of Arm Co. at the year end.

How is the investment in Leg Co. shown in Arm Co.'s group statement of financial position at 31 December 20X9?

A a trade investment of $160 000

B an investment in associate of $156 080

C an investment in associate of $175 680

D an investment in associate of $179 600

MODULE 6

1 Which of the following ratios provide a measure of profitability?

I. interest cover
II. dividend cover
III. return on equity
IV. gross profit margin

A I and IV only
B III and IV only
C I, II and IV only
D I, II, III and IV

2 Booth Co. has increased its return on investment (ROI) since last year. Assuming all other factors remain the same, which of the following is the best explanation for this?

A lower interest cover than last year
B a lower profit margin than last year
C a higher current ratio than last year
D a higher asset turnover than last year

3 Which of the following will cause a company's gearing ratio to increase?

A the payment of a dividend
B a decrease in rental expenses
C a decrease in the allowance for receivables
D the upward revaluation of a non-current asset

4 Allister Co. reports the following amounts in its statement of financial position:

	20X9	20X8
	$	$
Inventory	13 500	14 200
Receivables	?	12 840
Prepayments	1 280	1 880
Cash	348	–
Payables	10 760	17 200
Overdraft	–	1 200
Deferred tax	3 700	4 200

Assuming that Allister Co. maintained its quick ratio at the same level in 20X9, what was the receivables figure in that year?

A $1770
B $6980
C $7771
D $11 822

5 Extracts from Hunt Co.'s financial statements in the year ended 31 December 20X9 were as follows:

STATEMENT OF PROFIT OR LOSS	$
Gross profit	3 216 400
Earnings before interest and tax	2 468 400
Profit before tax	2 094 400
Profit after tax	1 870 000
Earnings per share	7.48c

Hunt Co. made no issues of shares during the year.

What was the number of Hunt Co. shares in issue throughout the year to the nearest million?

A 25 million
B 28 million
C 33 million
D 43 million

ANSWERS TO REVISION QUESTIONS

MODULE 1

1 A The provision of information aimed at running a business more efficiently is an objective of management accounting rather than financial accounting. The aim of financial reporting is the provision of information to meet the needs of external users.

2 A Suppliers' interest in their customers' accounts lies in the fact that they wish to be repaid in a timely fashion. They are therefore interested primarily in the liquidity of a company.

3 D In each case the reverse is correct: US accounting standards are rules-based and IFRS are principles-based.

4 D The IFRS Foundation is the overseeing body for the IASB, IFRS Interpretations Committee and IFRS Advisory Council. The Monitoring Board serves as a mechanism for communication between capital markets authorities and the IFRS Foundation.

5 B The IASB is responsible for issuing IFRS.

6 A The AASB has adopted IFRS equivalent standards (with changes made to reflect the Australian legislative environment). Although IFRS allows the use of the 'true and fair/fair presentation override', Australian companies' legislation does not.

7 D The entity's need for additional finance would be shown by its statement of financial position and information about its investing and financing activities would be shown by its statement of cash flows (and, to some extent, by its statement of financial position).

8 B Concepts and conventions are contained within the *Conceptual Framework*, however this is not the title of a chapter.

9 B One of the purposes of the *Conceptual Framework* is to enable the reduction of the number of alternative accounting treatments permitted by IFRS. Therefore I is incorrect.

10 B Its financial position (i.e. its assets and liabilities).

11 A Information about a reporting entity's cash flows during a period helps users assess the entity's ability to generate future net cash inflows.

12 D A change in accounting policy is applied retrospectively (as required by IAS 8), unless (a) it is impracticable to do so or (b) the change is required by a new IFRS and the transitional provisions require/allow prospective application.

A change in accounting policy may be made voluntarily, if the change will result in a more relevant or reliable presentation in the financial statements.

13 C Users of financial statements are entitled to assume that they have been prepared on the basis that the entity in question is a going concern, unless there is a clear statement to the contrary.

14 A Accounting standards do not apply to immaterial items.

15 C Verifiability and timeliness are not fundamental characteristics but are two of the four enhancing qualitative characteristics (the others are comparability and understandability).

16 B A faithful representation is complete, neutral and free from error.

17 B Departure from an IFRS is allowed where compliance would be misleading. Prior agreement with a regulatory body is not required.

18 A D is the definition of a liability; C is the definition of an asset; B is a mixture of the definitions of an asset and a liability.

19 D A provision is a liability of uncertain timing and/or amount – the amount is not necessarily an estimate; it may be known and the uncertainty surrounds timing of the payment. Provisions are recognised in the financial statements when certain criteria are met.

20 D A gain from the sale of a non-current asset is recognised as part of the profit or loss for the period but the revaluation of a non-current asset is not recognised in profit or loss (it is recognised in equity as part of other comprehensive income).

21 C The working capital of a business is its current assets and current liabilities.

22 A Prepayments are current assets; employee wages are an expense; a revaluation surplus forms part of equity.

23 A The amount spent on investigating the healing powers of the plant is research rather than development. At this stage it does not meet the recognition criteria as commercial development and economic benefit is too distant.

The training costs do not meet the definition of an asset as the resultant benefit is not controlled by the company (i.e. the trained staff could leave the organisation).

The advertising costs do not meet the definition of an asset as the resultant benefit is not controlled by the company and there is no certainty of a future economic benefit .

MODULE 2

1 D Realisable value.

2 A Historical cost is objective in that it is equivalent to the amount paid to obtain an asset. No estimation nor cost formulae are required.

3 A This is the definition of fair value contained within a number of IFRS.

4 D The first statement relates to normative theory and the second to positive theory.

5 C Operating capital maintenance is based on the productive capacity of an entity, and therefore requires a maintained level of assets.

6 C Under CPP accounting it is non-monetary items which are restated for the effects of general price inflation.

7 B A management buy-in is where external managers purchase the company.

8 C The Board of Directors are responsible for preparing the financial statements (even though the actual preparation is probably carried out by staff within the finance department with the assistance of the external auditors).

9 A The auditors' report must be disclosed in the financial statements. It gives an opinion as to whether the financial statements show a true and fair view and/or are fairly presented.

10 C A statement of financial position and statement of cash flows are required by IAS 1 and IAS 7; corporate governance disclosures are required as part of compliance with listing rules.

11 B B is not an advantage; competitors may use the information contained within such disclosures in order to gain advantages in the market.

12 A The details of the members of the various committees are detailed in the corporate governance report.

MODULE 3

1 B Dividends must not be reported in the statement of profit or loss and other comprehensive income as they are not an expense and therefore do not relate to the performance of an entity in a reporting period. Dividend payments are reported in the statement of changes in equity because they represent a transaction between the business and the equity owners in their capacity as owners.

2 D The credit sale is part of the company's normal operating cycle and so the receivable arising is classified as current.

The bank overdraft is repayable on demand and so classified as current.

The shares are a current asset investment.

3 D IAS 1 specifies what should be disclosed in the main financial statements.

4 B A loss on disposal and depreciation are non cash expenses and so must be added back in the reconciliation (a profit on disposal is non-cash income which must be deducted).

An increase in payables (or decrease in receivables or inventory) is added back in the reconciliation (a decrease in payables or increase in receivables or inventory is deducted).

Finance cost is added back to profit before tax in the reconciliation (investment income is deducted).

5 D

	$
Profit for the year	12 990
Depreciation	1 300
Purchase of NCAs	(6 500)
Increase in receivables	(560)
Decrease in inventories	1 100
Increase in payables	230
	8 560

6 B

	$
Carrying amount b/f	90 000
Disposals at carrying amount	(3 400)
Purchase of non-current assets (balancing figure)	4 900
Carrying amount c/f	91 500

7 B

	$
Profit (β)	520 000
Increase in working capital	(120 000)
Depreciation	190 000
Current asset investment	(800 000)
Loan	(230 000)
Share issue	1 400 000
Increase in cash	960 000

8 B

	$
Issue of shares	17 000
Issue of debentures	70 000
	87 000

Dividends received is a cash flow from investing activities.

Interest paid is a cash flow from operating activities.

9 D An external audit can only provide reasonable, not absolute, assurance.

MODULE 4

1 B The entity developing the item must be able to sell or use the asset but no formal written commitment to do so is required.

2 A An intangible asset need not be separable; it must be identifiable.
Development costs **must** be capitalised if the criteria laid down in IAS 38 are met.
An intangible asset can only be revalued where a fair value is established by reference to an active market.

3 C Although the production rights are not separable (i.e. capable of separate disposal), they are contractual and therefore meet the IAS 38 definition of identifiable. The rights must therefore be recognised as an intangible asset in their own right.

4 D IAS 38 does not require an intangible asset to be amortised where it is assessed to have an indefinite life. In this case the asset must be tested for impairment annually and whenever there are indications of impairment.

5 D The research costs should be written off to profit or loss.
Amortisation on the capitalised development costs commences on 1 October, and mirrors the expected sales pattern:

	$
Year 1	68 000
Year 2	68 000
Year 3	68 000
Year 4	68 000
Year 5	34 000
Year 6	34 000

Therefore the total charge to profit or loss is:

	$
Research costs	28 000
Amortisation (3/12 × 68 000)	17 000
	45 000

The development costs reported as an asset are therefore $340 000 – $17 000 = $323 000.

6 B

	Machine 1 $	Machine 2 $
Cost	450 000	250 000
Depreciation (4/10 and 3/15)	(180 000)	(50 000)
Carrying amount	270 000	200 000
FV less costs of disposal	285 000	195 000
Value in use	260 000	198 000
Therefore recoverable amount	285 000	198 000
Revised carrying amount	270 000	198 000
Total	270 000 + 198 000 = $468 000	

7 B

Carrying amount (900 000 × 24/25)		$864 000
Value in use	$860 000	
Fair value less costs of disposal ($870 000 × 95%)	$826 500	
Recoverable amount		$860 000
Impairment loss		$4 000

8 A An impairment loss relating to a CGU is initially allocated to any obviously impaired assets.
Corporate assets may be allocated to groups of CGUs where allocation to a single CGU cannot be achieved on a reasonable and consistent basis. An impairment loss recognised for goodwill shall not be reversed in a subsequent period.

9 D The impairment is allocated first to the goodwill. The remaining $30 000 is split between the property and machinery on a pro rata basis. Therefore, the machinery is measured at $50 000 – ($30 000 × 50/250) = $44 000. Note that IAS 36 does not apply to inventories or to financial assets within the scope of IAS 39; these would include receivables.

10 B Carrying amount of property at 31 December 20X9

	$
$600 000 × 18 / 20 years	540 000
Recoverable amount	535 000
Impairment loss	5 000

As the property has previously been revalued the impairment is charged against the revaluation surplus and reported as other comprehensive income.

11 C IFRS 15 says any of three criteria must be met for revenue to be recognised over a period of time. II and III are two of these and the third one is the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

12 D Revenue is not recognised on either transaction as Lord has not satisfied the performance obligations under both contracts.

13 A

	$
Customers expected to take up discount (450 000 × 40% × 95%)	171 000
Customers not expected to take up discount (450 000 × 60%)	270 000
Total	441 000

The sales tax is ignored as this is being collected on behalf of the tax authorities. For the customers who are expected to take up the discount revenue is recorded net of the settlement discount as it counts as variable consideration.

14 A

	$
Current tax (20X9)	52 300
Over-provision (43 800 – 42 120)	(1 680)
Deferred tax (79 320 – 69 780)	(9 540)
	41 080

15 B

	20X9	20X8
Carrying amount	526 260	495 300
Tax written down value	417 600	419 600
Temporary difference	108 660	75 700
× 20%	21 732	15 140

Increase in liability = charge to tax $21 732 – $15 140 = $6592

16 A Deferred tax amounts may not be classified as current.

Tax losses are an example of a deductible temporary difference.

17 A A deferred tax asset arises in respect of losses carried forward which can be utilised against future profits.

18 B The credit balance on the tax account represents the previous year's overprovision. This is deducted from the current year tax charge.

The current year liability is not adjusted for the over-provision.

19 D

	Settled payable	Outstanding payable
	$	$
Recorded in June (375 000 / 2) / 4.3	43 605	43 605
Settled (375 000 / 2) / 4.6	40 761	
Unsettled (375 000 / 2) / 4.5		41 667
Exchange gain	2 844	1 938
Total gain	4 782	

20 A

	$'000
Assets (560 / 0.8)	700
Share capital (100 / 0.75)	133
Retained earnings (β)	354
Liabilities (170 / 0.8)	213
	700

21 D

	$	$
Opening net assets at 4.3D / $	151 163	
Opening net assets at 4D / $	162 500	
Gain		11 337
Retained profits at 4.2D / $	27 381	
Retained profits at 4D / $	28 750	
Gain		1 369
Total gain		12 706

22 C The asset is a non-monetary asset and should not be re-translated at the year end; the payable is a monetary amount and must be re-translated.

23 C Exchange differences arising on settlement of currency items or the retranslation of monetary items are reported in profit or loss. Exchange differences arising on the translation of financial statements into the presentation currency are reported as other comprehensive income.

24 C The total amount payable of $26 000 will be spread over four years to give an annual expense of $6500.

25 D

	$
Deposit	18 000
Present value of future lease payments	150 000
	168 000
Depreciation	56 000
168 000 / 3 years	

MODULE 5

1 B Raleigh Co. cannot have significant influence over Well Co., since Slim Co. already has control and refuses to listen to Raleigh Co.
Vic Co. is an associate by virtue of the fact that Raleigh Co. has active representation on Vic Co.'s board of directors.

2 C Dry Co. controls Wet Co. by virtue of the fact that it directs the relevant activities (operating activities) of that company.
Dry Co. has significant influence over Cloud Co., evidenced by the 40 per cent shareholding and participation in the policy-making process.
Dry Co. has significant influence over Drizzle Co., evidenced by the 25 per cent shareholding.

3 C IFRS 10 requires that II, III and IV are all met in order to avoid presenting consolidated financial statements. I is irrelevant as where subsidiaries operate under long-term restrictions, control may have been lost. In this case, they are no longer subsidiaries and so consolidated accounts are not required, as there is no group.

4 D IFRS 10 states that all material subsidiaries should be consolidated; investments in group companies in individual entity accounts are held at cost or in accordance with IFRS 9; the accounting policies of the subsidiary must be brought in line with those of the group for the purposes of consolidation.

5 A Both B and D refer to control.

6 A Car Co.'s accounts should be adjusted as though the cash has been received. Therefore, the revised balances are:

Receivables	$60 000
Overdraft	$7 600

7 A

	$'000
Consideration	480
Fair value of NCI	45
	525
Fair value of net assets (100 + 320 + 30)	(450)
	75

8 B 20% × (620 000 + 75 000)

9 B

	$
Axis Co.	165 000
Yves Co.	180 000
NCA PURP adjustment (see below)	(5 478)
	339 522
Unrealised profit on sale	
$25 000 – ($32 000 – ($32 000 × 20% × 2))	5 800
Reduction in depreciation	
($32 000 × 20% × 2 / 12) – ($25 000 / 3yrs × 2 / 12)	(322)
	5 478

Alternatively, the adjustment can be calculated by comparing the carrying amount of the asset at the reporting date with the carrying amount had no transfer occurred:

Non-current asset post-transfer	
$25 000 – ($25 000 × 2 / 36 months)	23 611
Non-current asset if no transfer had occurred	
$32 000 – ($32 000 × 20% × 2 2 / 12yrs)	18 133
NCA PURP	5 478

10 B

	$
Try Co.	680 900
Ply Co. 80% (532 000 – 400 000)	105 600
Goodwill impairment 25% × 68 000	(17 000)
URP 20 / 120 × $50 000 × ½	(4 167)
	765 333

11 B

	P Co. $'000	S Co. × 2/12 $'000	Adj $'000	Group $'000
Revenue	2 900	300	(20)	3 180
Cost of sales	1 500	150	(20)	1 630
				1 550

12 D

An impairment is charged to admin expenses:	$'000
Ed Co.	100
Clem Co.	36
Impairment (450 000 – 415 000 – 5000) × 20%	6
	142

13 B 20X9 is not the year of transfer and therefore the URP is made up only of the difference in depreciation charge:

'Old' depreciation $400 000 × 10%	$40 000
'New' depreciation $340 000 / 8 yrs	$42 500

Therefore, an extra $2500 has been charged and must be adjusted for to reduce cost of sales.

14 B 20X9 is the year of transfer and therefore the URP is made up of the loss on transfer and the difference in depreciation charge:

	$	
Proceeds	200 000	
Carrying amount at transfer	(220 000)	
Loss on transfer	20 000	to add back to profit
Depreciation:		
'old' $300 000 / 15 × 2 / 12	3 333	
'new' $200 000 / 11 × 2 / 12	3 030	
	303	extra to charge to profit

Therefore, the overall adjustment is $19 697 to add back to profit.

15 B Dividend income relating to investments other than subsidiaries (and associates) is carried across to the consolidated statement of profit or loss.

Statement II is correct.

16 B

The associate's revenue is irrelevant to the calculation:	$'000
Roulston Co.	1 490
Hudson Co.	430
Roulston sales to Hudson	(400)
	1 520

17 C

	$
Dray Co.	86 500
Ray Co.	73 400
Sales from D to R	(40 000)
URP on sales from D to R (40 000 × 25/125)	8 000
	127 900

The URP on the sale to Lay Co. is adjusted against the share of profit of associate.

18 C The group share of the URP is adjusted against the investment in the associate:

	$
Cost	190 000
Share of post-acquisition profits	
$450 000 × 45%	202 500
URP ($15 000 × 20% × 45%)	(1 350)
	391 150

19 D Any impairment of an associate is charged against the profits of the associate.

20 C This is a parent associate relationship; significant influence is evidenced by the material transactions between the two companies.

	$
Cost of investment	160 000
Group share of post-acquisition profits	
16% × $98 000	15 680
	175 680

There is no unrealised profit, because all the goods have been sold on outside the group.

MODULE 6

1 B Interest cover is an indicator of solvency; dividend cover is an investor ratio.

2 D ROI is the product of profit margin and asset turnover. An increase in either of these will increase ROI. Interest cover and the current ratio are irrelevant to ROI.

3 A A decrease in expenses increases profits and so equity and decreases the gearing ratio.
A decrease in the allowance for receivables also increases equity.
An upward revaluation increases equity and so decreases the gearing ratio.
The payment of a dividend decreases equity and so increases the gearing ratio.

4 B The quick ratio of 20X8 was:

$$\frac{12\,840 + 1880}{17\,200 + 1200} = 0.8$$

Therefore in 20X9:

$$\frac{? + 1280 + 348}{10\,760} = 0.8$$

? + 1628	=	0.8 × 10 760
? + 1628	=	8608
Receivables	=	6980

5 A Earnings per share is calculated as the profits attributable to the ordinary shareholders divided by the number of shares. The profits attributable to ordinary shareholders is profit after tax and therefore:

$$\frac{1870\,000}{\text{No of shares}} = 0.0748$$

$$\text{No of shares} = \frac{1870\,000}{0.0748} = 25\text{m}$$

BEFORE YOU BEGIN QUESTIONS: ANSWERS AND COMMENTARY

MODULE 1

1 Differences include:

FINANCIAL ACCOUNTS	MANAGEMENT ACCOUNTS
Prepared annually (although quarterly in some jurisdictions)	Normally prepared monthly or quarterly, often on a rolling basis
Provide historic information	Provide historic information and future budgets/ forecasts
Are prepared in accordance with accounting regulations	Are not governed by any regulations
Contain summarised information	Contain detailed information
Prepared for external use	Prepared for internal use

2 Financial reporting is the process of recording, analysing and summarising financial data which is made available to a variety of user groups.

3 A reporting entity is defined in Australia as 'an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.' The 'reporting entity' concept is not, however, one that is currently adopted outside of Australia and at present international standard-setters have no official equivalent definition. Internationally therefore, a reporting entity is taken quite simply to be an entity, or group of entities which prepare accounts.

4 Knowledge of the main user groups of financial statements is important for any accountant:
- Shareholders and investors want to know how profitable their investment is.
- Management need financial information in order to run the company and make decisions.
- Suppliers want to know whether they will be paid and whether the business will continue into the future.
- Customers want to know whether they will have a continued supply.
- Lenders wish to know whether they will be repaid.
- Employees are interested in job security and whether they will be paid.
- The tax authorities are interested in profits for the purpose of calculating tax.
- The government is interested in companies' financial position from the perspective of the economy and national statistics.
- The public is interested in how companies affect the environment in which they operate.

5 GAAP is Generally Accepted Accounting Principles. It refers to all of the rules, from whatever source, that govern accounting in a particular jurisdiction. It may therefore include:
- national legislation
- accounting standards
- stock exchange requirements

6 The correct answer is B. Regulations are not necessarily relevant to all organisations. It is therefore a disadvantage of a regulatory system that some companies are bound by regulations which are not relevant to them.

7 The IASB is the International Accounting Standards Board. Its objectives include:
- to develop a single set of high quality, understandable, enforceable and globally acceptable financial reporting standards;
- to promote the use and rigorous application of those standards; and
- to promote and facilitate adoption of International Financial Reporting Standards (IFRSs), through the convergence of national accounting standards and IFRSs.

8 The IFRS Advisory Council was previously known as the Standards Advisory Council. The Council is made up of a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups who have an interest in international financial reporting. As such, the Council advises the IASB on agenda decisions, priorities in its work and the impact of standards in practice.

9 The IFRS Interpretations Committee assists the IASB in establishing and improving International Financial Reporting Standards, dealing with newly identified financial reporting issues not specifically addressed in IFRS, or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.

Knowledge of the regulatory bodies which contribute to the development of International Financial Reporting Standards is important.

10 A conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

11 Where there is no conceptual framework, the following problems may arise:

- Standards are produced in a haphazard manner and 'firefight' problems which have developed. In other words they are reactive rather than proactive.
- Contradictions and inconsistencies arise between standards.
- Standards develop which are 'rules-based' rather than 'principles-based'. These offer no flexibility and may result in incorrect reporting of the substance of transactions.

12 The correct answer is C. Additional objectives of the *Conceptual Framework* are to:

- assist preparers of accounts to apply IFRS
- assist preparers of accounts when dealing with topics which are not the subject of an IFRS
- assist users in interpreting financial statements
- provide information about the approach to the formulation of IFRS.

13 'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity'.

14 Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

15 A change in accounting policy is accounted for retrospectively i.e. the accounts are adjusted to reflect the situation as if the new accounting policy had always been in force.

16 A change in accounting estimate is accounted for prospectively i.e. the accounts are amended from the date of change.

17 Going concern is the assumption, when preparing a set of accounts, that an organisation will continue to operate for the foreseeable future (at least 12 months).

18 Substance over form is the principle that transactions are accounted for in accordance with their commercial substance rather than their legal form. Examples of its application include:

- recognising an asset acquired under a finance lease as a non-current asset
- producing consolidated accounts for groups of companies.

19 The qualitative characteristics of financial information are important; make sure that you know what they are and understand what they mean:

- The fundamental qualitative characteristics are: relevance and faithful representation.
- The enhancing qualitative characteristics are: comparability, verifiability, timeliness and understandability.

20 Financial information is relevant if it is capable of making a difference in the decisions made by users. Relevant financial information has predictive value, confirmatory value, or both.

21 Barriers to the global harmonisation of accounting standards include:

- the different purpose of financial reporting in different countries;
- different legal systems;
- an unwillingness of some countries to give up their own national standards;
- cultural differences;
- the need for more basic standards for developing countries and more sophisticated standards for developed countries; and
- unique circumstances such as hyperinflation in certain countries.

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

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

24 Equity is the residual interest in the assets of the entity after deducting all its liabilities.

These definitions of elements of the financial statements are applied throughout numerous IFRS. It is therefore important that you are familiar with them.

25 (a) The item must meet the definition of an element of the financial statements; and

(b) There must be a probable flow to or from the entity of any future economic benefit associated with the item; and

(c) The cost or value of the item must be capable of reliable measurement.

These recognition criteria are key, and you will find them repeated throughout a number of accounting standards.

26 The correct answer is D.

Assets and liabilities are presented broadly in order of liquidity only where this provides more relevant and reliable information.

An asset or liability settled in more than 12 months is classified as current if it is part of the normal operating cycle of the entity.

MODULE 2

1 Where the historical cost basis of measurement is applied:
- assets are recorded at the amount of cash paid or the fair value of consideration given to acquire them
- liabilities are recorded at the amount of proceeds received in exchange for the obligation.

2 Although the historical cost basis of measurement has a notable advantage in that it is objective, there are also a number of disadvantages, including the following:
- The historical cost of an asset does not reflect its replacement cost where there is inflation or prices have increased due to market conditions.
- Historical cost gives no indication of the realisable value of an asset.
- Comparisons over time are unrealistic.
- The cost of new non-current assets is aggregated together with the cost of some which may be very old, meaning that additions are not on a like for like basis.
- Historic cost does not capture the effect of some important transactions and events, for example, changes in the value of derivative financial instruments.

3 The correct answer is D. Deprival value is the loss that a business would suffer if it were deprived of the asset. Fair value and historical cost are measures of valuation.

4 Fair value is 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

5 A normative accounting theory is one which explains what should occur rather than what does.

6 Physical capital maintenance defines profit in terms of the increase in physical productive capacity over a period rather than in terms of the increase in monetary capital. Where physical capital is maintained, an entity is able to continue to operate at current levels of activity (having taken into account price inflation of raw materials and other costs).

7 Current purchasing power accounting measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

8 Current cost accounting requires that assets should be stated at their deprival value to the business. By taking account of changing prices, it therefore results in accounts which reflect the maintenance of the operating capability of a business.

9 An agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent.

10

PRINCIPAL	AGENT
Shareholders	Directors
Directors	Auditors
Directors	Employees

11 Corporate governance disclosures are important as they explain to the shareholders of an entity what steps the directors are taking to ensure that the company is run properly.

12 The advantages of disclosing non-mandatory information include:
- enabling shareholders to better understand the company and its environment;
- providing shareholders with more information on which to base an assessment of the stewardship of the directors; and
- allowing shareholders to access the information which interests them.

13 A corporate governance report details how the directors of an entity have complied with corporate governance regulations during the financial year. In particular, it may include information on the independence of non-executive directors, internal control systems, relationships with key shareholders and the members of audit and remuneration committees.

14 A corporate social responsibility report explains how an entity has addressed social issues such as the employment of disabled people or support of charities and environmental concerns such as levels of emissions.

Ensure that you know the contents of the supplementary information found in a set of financial statements.

MODULE 3

1 IAS 1 requires:
- statement of financial position;
- statement of profit or loss and other comprehensive income;
- statement of changes in equity;
- statement of cash flows; and
- notes to the financial statements.

2 An asset should be classified as a current asset when it:
- is expected to be realised in, or is held for sale or consumption in, the normal course of the entity's operating cycle;
- is held primarily for trading purposes or for the short-term and expected to be realised within 12 months of the end of the reporting period; or
- is cash or a cash equivalent asset which is not restricted in its use.

3 A liability should be classified as a current liability when it:
- is expected to be settled in the normal course of the entity's operating cycle;
- is held primarily for the purpose of trading;
- is due to be settled within 12 months after the end of the reporting period; or
- the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the end of the reporting period.

4 Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. It comprises all components of profit or loss and of other comprehensive income.

5 Other comprehensive income refers to items of income and expense which are not recognised in profit or loss, as they are not realised for example, a revaluation gain on a non-current asset.

6 IAS 1 allows the presentation of total comprehensive income either in a single **statement of profit or loss and other comprehensive income** or **in a separate statement of profit or loss and statement showing other comprehensive income**.

7 IAS 1 requires the following items to be disclosed in the profit or loss section of the statement of profit or loss and other comprehensive income:
(a) revenue
(b) finance costs
(c) share of profits and losses of associates and joint ventures accounted for using the equity method
(d) a single amount for the total of discontinued operations
(e) tax expense

8 To report transactions between a company and its shareholders in their capacity as shareholders.

9 A statement of cash flows shows a company's ability to pay its debts as they fall due, and the availability of cash to pay dividends, wages and so on. It is a useful indicator of liquidity and solvency.

10 Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

11 Cash flows from operating, investing and financing activities.

12 Cash generated by operations:

Cash received from customers	X
Cash paid to employees and suppliers	(X)
	X

13 Cash generated by operations:

Profit before tax	X
Add depreciation	X
Interest expense	X
Loss (profit) on sale of non-current assets	X
(Increase)/decrease in inventories	(X)/X
(Increase)/decrease in receivables	(X)/X
Increase/(decrease) in payables	X/(X)
Cash generated from operations	X

14 The advantages of cash flow accounting are as follows:

- Survival in business depends on the ability to generate cash. Cash flow accounting directs attention towards this critical issue.
- Cash flow is less subjective than 'profit' which is dependent on accounting conventions and concepts.
- Creditors (long- and short-term) are more interested in an entity's ability to repay them than in its profitability. Whereas 'profits' might indicate that cash is likely to be available, cash flow accounting is more direct with its message.
- Cash flow reporting provides a better means of comparing the results of different companies than traditional profit reporting.
- Cash flow reporting better satisfies the needs of all users.
  - For management, it provides the sort of information on which decisions should be taken (in management accounting, 'relevant costs' to a decision are future cash flows); traditional profit accounting does not help with decision-making.
  - For shareholders and auditors, cash flow accounting can provide a satisfactory basis for stewardship accounting.
  - As described previously, the information needs of creditors and employees will be better served by cash flow accounting.
- Cash flow forecasts are easier to prepare, as well as more useful, than profit forecasts.
- They can in some respects be audited more easily than accounts based on the accruals concept.
- The accruals concept is confusing, and cash flows are more easily understood.

15 The external auditor's primary role is to form an independent opinion on a set of financial statements and assess whether they are true and fair.

MODULE 4

1 An intangible asset is a non-monetary asset without physical substance.

2 At cost, providing that the recognition criteria are met, that is:
   (a) it is probable that the future economic benefits that are attributable to the asset will flow to the entity
   (b) the cost can be measured reliably

3 An intangible asset may only be revalued if it is part of an active market. An active market is one in which items traded are homogenous, willing buyers and sellers are available and prices are available to the public.

4 Internally generated goodwill, brands, mastheads, publishing titles and customer lists **may not** be capitalised as intangible assets.

5 Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

6 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

7 Research costs are expensed to profit or loss as incurred.

8 If all of the following six criteria are met, development costs must be capitalised:
   - The completion of the intangible asset so that it will be available for use or sale is technically feasible.
   - There is an intention to complete the intangible asset and use or sell it.
   - The intangible asset can be used or sold.
   - The intangible asset will generate probable future economic benefits. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
   - Adequate technical, financial and other resources to complete the development and to use or sell the intangible asset are available.
   - The expenditure attributable to the intangible asset during its development can be measured reliably.

   These criteria are important and worth learning. Note how they mirror (in more detail) the recognition criteria of the *Conceptual Framework*.

9 Indicators of impairment may be external or internal. They are largely based on common sense:
   - External sources of information
     – A fall in the asset's market value that is more significant than would normally be expected from passage of time or normal use.
     – A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.
     – An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.
     – The carrying amount of the entity's net assets being more than its market capitalisation.
   - Internal sources of information: evidence of obsolescence or physical damage, adverse changes in the use to which the asset is put, or the asset's economic performance.

10 Even if there are no indications of impairment, the following assets must **always** be tested for impairment annually:
   - an intangible asset with an indefinite useful life
   - an intangible asset which is not yet available for use
   - goodwill acquired in a business combination

11 The recoverable amount of an asset should be measured as the higher value of:
- the asset's fair value less costs of disposal; and
- its value in use.

Learn this definition as it will be the key to correctly answering many questions.

12 An impairment loss must be recognised when the recoverable amount of an asset is less than its carrying amount.

13 An impairment loss relating to an asset held at historical cost is recognised in profit or loss; an impairment loss relating to a revalued asset is recognised as a revaluation decrease in accordance with the relevant standard.

14 A cash-generating unit is the smallest identifiable group of assets for which independent cash inflows can be identified and measured.

15 Impairment losses are allocated to a CGU in the following order:
1. first, to any assets that are obviously damaged or destroyed;
2. next, to the goodwill allocated to the cash generating unit; and
3. then to other assets in the cash-generating unit, on a pro rata basis.

16 IFRS 15 *Revenue from Contracts with Customers*

17 The model is as follows:
1. identify the contract with a customer
2. identify the separate performance obligations in the contract
3. determine the transaction price
4. allocate the transaction price to the performance obligations
5. recognise revenue when (or as) the entity satisfies a performance obligation

18 Current tax is the estimated amount payable to the tax authorities in relation to the trading activities of the entity during the period. It is calculated by applying the tax rate to taxable profits.

19 The correct double entry is:

Dr. Tax expense (profit or loss)

Cr. Tax liability (statement of financial position)

20 An over-provision of current tax arises where the liability recorded at one year end exceeds the amount of tax actually paid in the next period. An over-provision reduces the following year's tax charged to profits.

An under-provision is the opposite and increases the following year's tax charged to profits.

21 Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact.

22 A temporary difference is the difference between the carrying amount of an asset or liability and its tax base.

23 The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount.

24 A taxable temporary difference arises where the carrying amount of an asset exceeds its tax base or the carrying amount of a liability is less than its tax base. It results in a deferred tax liability.

25 Common transactions which result in taxable temporary differences include the following:
- Interest revenue received in arrears and included in accounting profit on the basis of time apportionment. It is included in taxable profit, however, on a cash basis.
- Depreciation of an asset is accelerated for tax purposes. When new assets are purchased, allowances may be available against taxable profits which exceed the amount of depreciation chargeable on the assets in the financial statements for the year of purchase.
- Development costs which have been capitalised will be amortised through profit or loss, but they were deducted in full from taxable profit in the period in which they were incurred.

- Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

It is worth learning this list (and that below relating to deductible temporary differences) so that you can deal with exam questions on deferred tax quickly and without confusion.

26 A deductible temporary difference arises where the tax base of an asset exceeds its carrying amount or the tax base of a liability is less than its carrying amount. It results in a deferred tax asset.

27 Common transactions which result in deductible temporary differences include:

- Retirement benefit costs (pension costs) are deducted from accounting profit as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)
- The NRV of inventory, or the recoverable amount of an item of property, plant and equipment falls and the carrying amount is therefore reduced, but that reduction is ignored for tax purposes until the asset is sold.
- Research costs (or organisation/other start-up costs) are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.
- Income is deferred in the statement of financial position, but has already been included in taxable profit in current/prior periods.
- Tax losses arise which are carried forward against future taxable profits.

28 IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply in the period when the asset is realised or liability settled, based on tax rates and laws enacted (or substantively enacted) at the end of the reporting period.

29 As with current tax, deferred tax should normally be recognised as income or an expense and included in the net profit or loss for the period in the statement of profit or loss and other comprehensive income. Deferred tax (and current tax) should be charged or credited to other comprehensive income or directly to equity if the tax relates to items also charged or credited to other comprehensive income or directly to equity (in the same or a different period).

30 The tax on profit on ordinary activities is calculated by aggregating:

- income tax on taxable profits
- transfers to or from deferred taxation
- any under-provision or over-provision of income tax on profits of previous years

31 The currency of the primary economic environment in which the entity operates.

32 The currency in which the financial statements are presented.

33 At the spot rate in force on the date of the transaction.

34 An exchange difference arises either:

- on the settlement of the item; or
- where a monetary item is retranslated at the period end.

Such exchange differences are recognised in profit or loss.

35 **Monetary items** are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

36 Assets and liabilities are translated at the closing rate.

Share capital and pre-acquisition reserves are translated at the acquisition-date rate

Post-acquisition reserves are a balancing figure.

37 The exchange rate in force on the date of each transaction should be applied, however for practical purposes, all items in the statement of profit or loss are usually translated at the average rate.

Learn the rules in the answers to 36 and 37.

38 The exchange difference is made up of two elements:
   1. the difference between opening net assets translated at the opening and closing rates
   2. the difference between retained earnings for the year translated at the average and closing rates

39 Leases are accounted for by recognising a right of use asset and a corresponding liability.

40 The standard allows the lessee to elect to not apply IFRS 16 for short-term leases – this is a lease for a period of time that is for less than 12 months. Low value leases – this is when the underlying asset has a low value when new.

MODULE 5

1 A subsidiary is an entity that is controlled by another entity.

2 An associate is an entity over which an investor has significant influence.

3 IFRS 10 states that an investor controls an investee if, and only if, it has all of the following:

1. power over the investee;
2. exposure to, or rights to, variable returns from its involvement with the investee; and
3. the ability to use its power over the investee to affect the amount of the investor's returns.

Power over an investee is normally obtained directly from ownership of the majority of voting rights, but it can be derived from other rights, such as:

- rights to appoint, reassign or remove key management personnel who can direct the relevant activities
- rights to appoint or remove another entity that directs the relevant activities
- rights to direct the investee to enter into, or veto changes to, transactions for the benefit of the investor
- other rights, such as those specified in a management contract.

4 IAS 28 states that if an investor holds 20 per cent or more of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, **unless** it can be clearly shown that this is not the case. The existence of significant influence is evidenced in one or more of the following ways:

- representation on the board of directors (or equivalent) of the investee
- participation in the policy-making process
- material transactions between investor and investee
- interchange of management personnel
- provision of essential technical information

5 A subsidiary is consolidated and an associate is equity accounted.

6 All entities meeting the definition of a subsidiary must be consolidated. **Note:** There is one exception to this rule required by IFRS 5, but this is not on the FAR syllabus.

7 The non-controlling interest is the share of the subsidiary not owned by the parent company. It is measured at acquisition as either:

- the relevant proportion of the fair value of the net assets of the subsidiary; or
- fair value.

8 The assets and liabilities of the parent and subsidiary are added together on a line by line basis. Share capital in the consolidated statement of financial position is that of the parent company only.

9 Goodwill arises when the consideration transferred by the parent plus the non-controlling interest of the subsidiary at acquisition exceeds the fair value of the net assets of the subsidiary at acquisition.

10 Positive goodwill is recognised as a non-current asset in the consolidated statement of financial position. It is not amortised but is tested for impairment annually.

11 Goodwill is calculated as:

Consideration transferred	X
Non-controlling interest	X
	X
Net assets of acquiree	(X)
Goodwill	X

12 A bargain purchase (or negative goodwill) is re-assessed and any remaining amount is recognised immediately in profit or loss.

13 IFRS 3 requires the acquisition-date fair value of contingent consideration to be recognised as part of the consideration for the acquiree.

14 An unrealised profit arises where one group company has sold goods (or a non-current asset) at a profit to another group company during an accounting period, but these goods have not been sold on to a third party outside the group.

15 An unrealised profit (URP) must be adjusted for on consolidation by

Dr. Group retained earnings

Cr. Inventory/non-current assets

Where the subsidiary is the selling company and there is a non controlling interest, the entry is:

Dr. Group retained earnings (with group share of URP)

Dr. NCI (with NCI share of URP)

Cr. Inventory/non-current assets

16 The subsidiary's statement of financial position must be adjusted to show fair values. These fair values are incorporated into the consolidation and also into the calculation of goodwill.

17 The income and expenses of the parent and subsidiaries are added across on a line by line basis. Dividend income received by the parent from subsidiaries is eliminated.

18 The non-controlling interest in profit is calculated as:

NCI % × profit of subsidiary (after consolidation adjustments attributable to the subsidiary)

19 The amount of the sales made in the period is eliminated from group sales and the same amount is eliminated from group cost of sales.

20 The cost of sales of the selling company is increased by the amount of the URP in the consolidation schedule.

21 Where the transfer has taken place in the year, the URP includes two elements:

- the profit or loss recorded by the selling company on the transfer
- the extra depreciation charged as a result of the transfer

22 The results of the subsidiary must be pro-rated prior to consolidation so that only the post-acquisition results are included in the group statement of profit or loss.

23 An impairment of goodwill in the year is normally charged to administrative expenses.

24 An associate is accounted for using the equity method.

25 The group share of the associate's profit after tax for the year is included in the consolidated statement of profit or loss in one line immediately before group profit before tax.

26 In the consolidated statement of financial position an investment in associate is included as a non-current asset calculated as:

Cost of the investment in the associate	X
Group share of post-acquisition profits	X
Any amounts paid out as dividends	(X)
Any amount written off the investment	(X)
	X

27 The group share of the unrealised profit is adjusted by:

Dr. Share of profit or loss of associates

Cr. Investment in associate

28 Any impairment loss arising in the year is charged against the group share of the associate's profits recognised in the consolidated statement of profit or loss.

The investment in associate in the consolidated statement of financial position is shown net of accumulated impairment losses.

MODULE 6

1 **Horizontal analysis** involves comparing one company's financial statements directly with those of another similar company and considering why differences may be evident.

2 Trend analysis involves comparing the results of one company over time.

3 Ratios may be classified into the following groups:
- profitability
- liquidity/efficiency
- solvency
- investor ratios

4 $$\text{ROI} = \frac{\text{Earnings before interest and tax}}{\text{Total assets} - \text{Current liabilities}} \times 100\%$$

ROI is sometimes called return on capital employed (ROCE).

5 ROI indicates how well management are utilising the resources available to them to make profits.

6 $$\text{Asset turnover} = \frac{\text{Sales}}{\text{Total assets} - \text{Current liabilities}}$$

7 Asset turnover is a measure of how well the assets of a business are being used to generate sales.

8 Gearing and interest cover provide an indication of solvency.

9 Leverage is an alternative name for gearing. A high level of gearing is risky as the high level of fixed interest makes the shareholders' dividend return more susceptible to volatile profits. In turn, this risk makes both equity and loan finance investors less willing to invest in the company.

10 $$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

11 The quick ratio excludes inventory from current assets in the calculation above.

12 $$\text{Receivables' days} = \frac{\text{Receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

13 Inventory days indicates the time for which an entity holds goods before they are sold.

14 An increase in payables' days is often a sign of lack of long-term finance or poor management of current assets, resulting in the use of extended credit from suppliers. Where payment exceeds credit terms, supply may be halted, which may impact a business significantly.

15 $$\text{Earnings per share} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Number of ordinary shares}}$$

16 Dividend cover shows the proportion of profit for the year that is available for distribution to shareholders that has been paid (or proposed) and what proportion will be retained in the business to finance future growth.

Dividend yield is the return a shareholder is currently expecting on the shares of a company.

17 A high P/E ratio indicates strong shareholder confidence in the company and its future.

The formulae to calculate the various ratios within this module must be learned.

18 The limitations of financial statements include:
- They are usually based on historical cost information which can be out of date.
- They may be subject to manipulation or creative accounting.
- Significant transactions near the year end, seasonal trading and related parties may all distort results.
- The effects of different accounting policies reduce comparability.

19 Limitations of ratio analysis include the following:

- In a company's first year of trading there will be no comparative figures. So there will be no indication of whether or not a ratio is improving.
- Comparison against industry averages may not be that revealing. A business may be subject to factors which are not common in the industry.
- Ratios based on historic cost accounts may be out of date. In particular, undervalued assets will distort ROI and exaggerate gearing.
- Ratios are influenced by the choice of accounting policy. For instance, a company seeking to maintain or increase its ROI may choose not to revalue its assets.
- Financial statements are subject to manipulation and so are the ratios based on them. Creative accounting is undertaken with key ratios in mind.
- Inflation over a period will distort results and ratios. Profit before tax, and therefore ROI, can be inflated where FIFO is applied during an inflationary period.
- No two companies, even operating in the same industry, will have the same financial and business risk profile. For instance, one may have better access to cheap borrowing than the other and so may be able to sustain a higher level of gearing.

GLOSSARY OF TERMS

GLOSSARY OF TERMS

Accounting. The process of identifying, measuring, recording and communicating economic information to others so that they may make resource allocation decisions on the basis of that information.

Accounting policies. The specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

Accounting standards. Authoritative statements of how particular types of transactions and other events should be reflected in the financial statements.

Accrual accounting. Depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Accruals concept. Items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the *Conceptual Framework*. Therefore items of income and expenditure are matched and accounted for in the period in which they were earned/incurred rather than when the cash was received or paid.

Agency relationship. A contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent.

Asset. A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Assets to equity ratio. Assets (non-current assets plus net current assets) compared to shareholders' funds. A measure of gearing (leverage).

Asset turnover. Sales compared to investment (capital employed). Can be calculated as sales compared to total assets or sales compared to total assets less current liabilities.

Associate. An entity over which the investor has significant influence.

Assurance engagement. An engagement in which a practitioner aims to obtain sufficient appropriate evidence to express a conclusion designed to enhance the degree of confidence of the intended users about the subject matter.

Audit. A type of assurance engagement carried out by an external auditor to provide an independent opinion on an entity's financial statements.

Auditor's report. Sets out the auditors' opinion of the financial statements and states whether they show a true and fair view/fair presentation of the financial performance and financial position of the entity.

Business entity concept. The concept that financial accounting information relates only to the activities of the business entity and not to the activities of its owner(s).

Capital gearing ratio. A measure of the proportion of a company's capital that is debt.

Carrying amount. The amount at which an asset is recognised after deducting accumulated depreciation and any impairment losses.

Cash. Cash on hand and demand deposits.

Cash equivalents. Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows. Inflows and outflows of cash and cash equivalents.

Cash-generating unit. The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Change in accounting estimate. An adjustment of the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.

Closing rate. The spot exchange rate at the year end date.

Comparability. Accounting policies used should be disclosed, to make it possible for users to compare the company's results with its own prior years and with the results of other companies.

Conceptual framework. A statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

Conceptual Framework for Financial Reporting ('Conceptual Framework'). The IASB's conceptual framework upon which all IFRSs are based. It determines how financial statements are prepared and the information they contain.

Consolidated financial statements. The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Control. An investor (a parent) controls an investee (a subsidiary) when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Corporate governance. The framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It encompasses the mechanisms by which companies, and those in control, are held to account.

Cost model. Assets are measured at amounts based on their historical cost. For example, a non-current asset is carried at its cost less depreciation and any accumulated impairment loss.

Current assets. Assets used in the trading activities of the business such as inventory, trade receivables and cash at bank.

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Current Cost Accounting (CCA). Reflects an approach to capital maintenance based on maintaining the operating capability of a business and so measures assets at their value to the business (deprival value).

Current liabilities. Amounts due in the shorter term such as trade payables and sales tax.

Current purchasing power (CPP). Measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

Current ratio. Ratio of current assets to current liabilities

Current tax. The amount payable to the tax authorities in relation to the trading activities of the period.

Debt to total assets. Interest bearing debt compared with total assets. A measure of gearing (leverage).

Deductible temporary differences. Temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Deferred tax. An accounting measure, used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results.

Deferred tax assets. The amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences
- the carry forward of unused tax losses
- the carry forward of unused tax credits.

Deferred tax liabilities. The amounts of income taxes payable in future periods in respect of taxable temporary differences.

Depreciation. A method of spreading the cost of non-current assets over their useful lives with an annual charge to profit or loss.

Deprival value. The lower of replacement cost and recoverable amount. In turn the recoverable amount is the higher of net realisable value and economic value.

Development. The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

Directors' report. A report contained in the annual report which gives a fair review of the development of the business during the year and of its position at the end of it.

Dividend cover. Ratio of earnings per share to dividend per share.

Dividend yield. The return a shareholder is currently expecting on the shares of a company.

Earnings per share (EPS). The amount of profit before tax for the period that is attributable to each ordinary share which is outstanding during all or part of the period.

Economic value (EV), or value in use. What the existing asset will be worth to the company over the rest of its useful life, that is, the present value of future cash flows associated with the asset.

Equity. The residual interest in the assets of the entity after deducting all its liabilities.

Equity method. A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

Exchange difference. The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate. The ratio of exchange for two currencies.

Expenses. Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

External auditor. Undertakes an external audit of an entity's financial statement, makes an independent opinion as to whether those financial statements are true and fair, and is independent of that entity.

Fair. Information is free from discrimination and bias and in compliance with expected standards and rules. The accounts should reflect the commercial substance of the company's underlying transactions.

Fair value. 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.

Faithful representation. Information that is faithfully represented is complete, neutral and free from error.

Financial accounting. The accounting processes required for reporting the results and financial position of a business and other economic information about a business to others so that they may make decisions on the basis of that information.

Financial capital maintenance. Profit is the increase in money capital over the period. It can be measured in either nominal monetary units or units of constant purchasing power.

Financial reporting. The process of classifying, recording and presenting financial data in accordance with generally established concepts and principles.

Foreign currency. A currency other than the functional currency of the entity.

Functional currency. The currency of the primary economic environment in which the entity operates.

Future economic benefit. The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

Gains. Increases in economic benefits. As such they are no different in nature from revenue.

Gearing. Gearing represents the proportion of the company's financing on which a return must be paid regardless of profitability. Also known as leverage.

Generally accepted accounting principles (GAAP). Signifies all the rules, from whatever source, which govern accounting.

Going concern concept. The entity is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Goodwill. Any excess of the consideration transferred in order to obtain control of another entity plus the non-controlling interest in that entity over the fair value of the identifiable assets and liabilities of the entity as at the date of the exchange transaction.

Group. A parent and its subsidiaries.

Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.

Impairment. A fall in the value of an asset, so that its 'recoverable amount' is now less than its carrying amount in the statement of financial position.

Impairment loss. The amount by which the carrying amount of an asset exceeds its recoverable amount.

Income. Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Intangible assets. Non-monetary assets without physical substance.

Interest cover. A ratio that shows whether a company is earning enough profits before interest and tax to pay its interest costs comfortably, or whether its interest costs are high in relation to the size of its profits.

Intra-group trading. Trading/transactions between companies in a group.

International Accounting Standards Board (IASB). An independent, privately-funded accounting standard-setter. It is responsible for the setting of International Financial Reporting Standards (IFRSs).

International Auditing and Assurance Standards Board (IAASB). An independent standard setting body, responsible for setting standards on auditing, assurance and other related areas and for facilitating their adoption and implementation.

International Financial Reporting Standards (IFRSs). The accounting standards issued by the IASB. Earlier accounting standards were known as International Accounting Standards (IASs) and many of these are still in issue.

International Financial Reporting Standards Advisory Council. Provides a formal vehicle to give advice to the IASB.

International Financial Reporting Standards Foundation (IFRS Foundation). An independent body that oversees the IASB.

International Financial Reporting Standards Interpretations Committee. Provides timely guidance on the application and interpretation of International Financial Reporting Standards.

International Standards on Auditing (ISAs). Global auditing standards issued by the IAASB and used by auditors in the external audit of financial statements.

Inventory turnover. Number of times in a year that inventory is 'turned over' or replaced in the warehouse.

Inventory turnover period. Number of days inventories (or stocks of goods) are held for.

Leverage. Leverage represents the proportion of the company's financing on which a return must be paid regardless of profitability. Also known as gearing.

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

Liquidity. The availability of sufficient funds to meet short-term financial commitments as they fall due.

Losses. Decreases in economic benefits. As such they are no different in nature from other expenses.

Management accounting. The process of identifying, measuring and communicating the information used by management to plan and control within an entity.

Management commentary. A narrative report that provides users with explanations of the amounts presented in the financial statements. It also provides commentary on an entity's prospects and other information not presented in the financial statements.

Materiality. Information is material if omitting it or misstating it could influence the economic decisions that users make on the basis of financial information about a specific reporting entity.

Measurement. The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income.

Monetary items. Units of currency held, and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Net realisable value. The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Non-controlling interest. The shares in a subsidiary that are not owned by the parent company.

Non-current assets. Assets for long-term use within the business.

Non-current liabilities. Long-term liabilities usually due after more than one year.

Normative accounting theory. Explains what should occur rather than what actually does occur.

Obligation. A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

Operating cycle of an entity. The time between the acquisition of assets for processing and their realisation in cash or cash equivalents.

Operating or Physical capital maintenance. Profit is the increase in the physical productive capacity over the period.

Other comprehensive income. Items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs.

Parent. An entity that controls one or more entities (known as subsidiaries).

Payables payment period. Number of days of credit taken from suppliers.

Performance obligation. A promise in a contract to transfer to a customer goods or services that are distinct.

Positive accounting theory. One where accounting theory is thought of as a body of knowledge that explains/predicts actual accounting practice.

Post-acquisition profits. Profits earned by a subsidiary since the date of acquisition.

Power. Existing rights that give an investor the current ability to direct the relevant activities of its investee.

Present obligation. Obligation existing at the present time.

Presentation currency. The currency in which the financial statements are presented.

Price/Earnings (P/E) ratio. The ratio of a company's current share price to the earnings per share.

Prior period errors. Omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation.

Profit. The excess of revenue (income) over expenditure. When expenditure exceeds revenue, the business is running at a loss.

Profit margin. Profit as a percentage of sales. Can be based on gross profit, earnings before interest and tax or profit after interest, tax and preference dividends.

Prospective application. Relates to a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, by:

- applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
- recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

Provision. A present obligation which satisfies the rest of the definition of a liability, even if the amount or timing of the obligation has to be estimated.

Quick ratio. Ratio of current assets minus inventory to current liabilities – also known as the acid test ratio.

Reasonable assurance. A high, but not absolute, level of assurance.

Receivables collection period. Number of days taken to collect receivables outstanding.

Recognition. The process of incorporating an item that meets the definition of an element in the statement of financial position or statement of profit or loss and other comprehensive income.

Relevance. Relevant financial information is capable of making a difference in the decisions made by users.

Reliable financial information. This has the following attributes:

- It reflects the substance of transactions i.e. represents faithfully what has taken place.
- It is free from bias, or neutral.
- It is free from material error.
- It is complete.
- Prudence (or caution) has been applied where there is any uncertainty.

Replacement cost. The amount needed to replace an item with an identical item. This is the same as current cost.

Reporting entity. An entity for which there are users who rely on the financial statements as their major source of financial information about the entity.

Research. Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Residual value. The net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Retrospective application. Applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Return on assets (ROA). States the earnings before interest and tax as a percentage of total assets.

Return on equity (ROE). States profit after interest, tax and preference dividends as a percentage of shareholders' funds.

Return on investment (ROI). States the earnings before interest and tax as a percentage of the amount of investment (total assets less current liabilities). Sometimes called return on capital employed (ROCE).

Revaluation. Restatement of assets and liabilities, giving rise to increases or decreases in equity.

Revaluation model. Non-current assets are carried at a revalued amount, being their fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

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

Revenue expenditure. Expenditure incurred for the purpose of the trade of the business or to maintain the existing earning capacity of non-current assets.

Sales tax. A tax paid over to governments on each transaction but borne by the eventual consumer – also known as GST in some countries, including Australia.

Settlement value. The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy a liability in the normal course of business.

Significant influence. The power to participate in the financial and operating policy decisions of an investee but is not control or joint control over those policies.

Solvency. The availability of cash over the longer term to meet financial commitments as they fall due.

Spot exchange rate. The exchange rate for immediate delivery.

Statement of cash flows. A statement showing all movements of cash and cash equivalents into and out of a business during the accounting period.

Statement of changes in equity. A statement showing the movement in the various components of equity (share capital, retained earnings and other reserves) for a period.

Statement of financial position. Primary financial statement which lists the assets, liabilities and owners' equity of a business. Sometimes referred to as a balance sheet.

Statement of profit or loss. Statement showing the income of the business less expenses giving a final figure for profit. Sometimes referred to as an income statement, or a profit or loss account.

Statement of profit or loss and other comprehensive income. Primary financial statement showing profit or loss for the period (see above) plus items of other comprehensive income (gains or losses which are not recognised in profit or loss such as gains or losses on revaluation of non-current assets). Sometimes referred to as a statement of comprehensive income.

Subsidiary. An entity that is controlled by another entity (known as the parent).

Substance over form. The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Tax base of an asset or liability. The amount attributed to that asset or liability for tax purposes.

Taxable temporary differences. Temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Timeliness. Financial information should be available in time to be capable of influencing users' decisions.

Trade payables. The amounts due to credit suppliers.

Trade receivables. The amounts owed by credit customers.

True. Information is factual and conforms with reality and required standards and law. The financial statements have been correctly extracted from the books and records.

Understandability. Financial information needs to be capable of being understood by users 'having a reasonable knowledge of business and economic activities and accounting'.

Unmodified opinion. The opinion expressed by an external auditor when they conclude that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Useful life. One of two things:

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an entity.

Value in use. The present value of estimated future cash flows (inflows minus outflows) generated by an asset, including its estimated net disposal value (if any) at the end of its expected useful life.

Verifiability. Information is verifiable if different observers can broadly agree that a particular way of presenting an item is a faithful representation.

FORMULAE

FORMULAE

These formulae are used in Module 6, Analysis of financial statements.

Earnings before interest and tax	(a) The profit before taxation; **plus** (b) Interest; plus (c) Tax
Return on Investment (ROI)	$\frac{\text{Earnings before interest and taxation}}{\text{Total assets } \textit{less} \text{ current liabilities}} \times 100\%$
Profit margin × Asset turnover = Return on investment	$\frac{\text{EBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Investment}} = \frac{\text{EBIT}}{\text{Investment}} = \text{ROI}$
Return on assets (ROA)	$\frac{\text{Earnings before interest and tax}}{\text{Total assets}} \times 100\%$
Return on equity (ROE)	$\frac{\text{Profit after tax and preference dividend}}{\text{Shareholders' equity}} \times 100\%$
Profit margin × Asset turnover × Assets to equity = Return on equity	$\frac{\text{Profit after tax and preference dividend}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}} = \text{ROE}$
Gearing	$\frac{\text{Interest bearing debt}}{\text{Shareholders' equity} + \text{interest bearing debt}} \times 100\%$
Assets to equity ratio	$\frac{\text{Non-current assets + net current assets}}{\text{Shareholders' equity}} \times 100\%$
Debt to total assets ratio	$\frac{\text{Interest bearing debt}}{\text{Total assets}} \times 100\%$
Equity to assets ratio	$\frac{\text{Shareholders' equity}}{\text{Non-current assets + net current assets}} \times 100\%$
	or $\frac{\text{Shareholders' equity}}{\text{Total assets } \textit{less} \text{ current liabilities}} \times 100\%$
Interest cover	$\frac{\text{Earnings before interest and tax}}{\text{Interest charges}}$
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$
Quick ratio	$\frac{\text{Current assets } \textit{less} \text{ inventory}}{\text{Current liabilities}}$
Accounts receivable collection period	$\frac{\text{Trade receivables}}{\text{Sales}} \times 365 \text{ days}$
Inventory turnover period	$\frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$
Inventory turnover	$\frac{\text{Cost of sales}}{\text{Inventory}}$
Accounts payable payment period	$\frac{\text{Trade accounts payable}}{\text{Purchases}} \times 365 \text{ days}$

Earnings per share (EPS)	$\frac{\text{Profit attributable to ordinary shareholders}}{\text{Number of ordinary shares in issue}}$
Dividend cover	$\frac{\text{Earnings per share}}{\text{Dividend per (ordinary) share}}$
Price earnings (P/E) ratio	$\frac{\text{Current share price}}{\text{EPS}}$
Dividend yield	$\frac{\text{Dividend per share for the year}}{\text{Current market value of the share (ex-div)}} \times 100\%$

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