3RD EDITION

THE COMPLETE GUIDE TO

INTERNATIONAL FINANCIAL REPORTING STANDARDS

INCLUDING IAS AND INTERPRETATION

RALPH TIFFIN

Inside Front Cover

The complete guide to

International Financial Reporting Standards

Including IAS and Interpretation

Ralph Tiffin

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Ralph Tiffin is a mechanical engineer who subsequently qualified as a Chartered Accountant and became manager in one of the largest international firms of accountants. He is now managing partner of an accountancy and consultancy practice. He has a wealth of experience with companies of all sizes in the UK and overseas. Work typically involves developing clients reporting and management systems along with appropriate management training and developing project appraisal processes and spreadsheets.

This book is an aid to understanding the purpose of IFRS's, the principal accounting and disclosure issues and problem areas. To ensure proper and detailed application of the Standards it will be necessary to refer to the Standards, authoritative supporting pronouncements and possibly seek appropriate expert opinion.

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1
Introduction

Accounting, used in this context to mean the recording and presentation of business events in traditional financial statements (the balance sheet, profit & loss account or income statement), is believed by many to be an exact science. For many accountants, rules (though not all are written down), convention and practice mean that events will always be recorded correctly and presented fairly.

However, several difficulties present themselves: there are genuine differences in opinion as to exactly how events should be recorded and presented; there is also the possibility of distorting both the recording and the presentation; and finally, there is the question of what transactions and events should be included in each set of financial statements.

Therefore there is a fundamental need for the existence and application of Accounting Standards. There is the need for consistency throughout the business world, the prevention of misleading presentation and disclosure of events.

The purpose of this text

The purpose of this text is to explain the principles of extant International Accounting Standards (IAS). These have been re-titled International Financial Reporting Standards (IFRS) as new Standards are introduced and collectively IAS's and the more recent IFRS's are known as IFRS's.

The text is aimed at: anyone in business who has to interface with published accounts and internal reports; or who is responsible for reports that are affected by or lead to published accounts. As never before, professional advisers, directors and executive officers from functions other than finance are affected by the requirements of Accounting Standards. Accountants and students of accountancy will also find this text useful as a summary of Accounting Standards, as it cuts through to exactly what the Standards aim to achieve and thus what has to be accounted for and disclosed.

Why do we need Accounting Standards?

There are different views on how to account for and report business transactions. These may be due to cultural or commercial reasons or because of legislative or taxation laws. A prime aim of Accounting Standards is to bring consistency of reporting within and between countries. Investors and others using financial statements (for example, for investing or benchmarking purposes) can then make decisions based on consistently prepared data.

However, consistency is not the only reason why Accounting Standards are needed. There can be poor or down right bad accounting. Poor accounting may mean lack of exactness giving a wide range of values or inadequate disclosure. Bad accounting could mean fraud.

Why do YOU need to understand Accounting Standards?

Owners, directors, managers and professional advisers, such as lawyers, have a responsibility to understand how business activities are presented in the financial statements – i.e. is the reality of what is going on in the business being properly and fairly presented. To appreciate if this is the case an understanding of the requirements is needed.

Where is IFRS today? Where is IFRS heading?

IFRS is well (or maybe that should be fairly well!) established in the EU and many other countries. China and India are well underway in establishing the use of IFRS. The US has indicated that IFRS will become acceptable from 2011 or 2014 (depending to whom you talk!). However, there are difficulties and dissenters to further (or in some cases full) adoption and proper consistent convergence of national standards to IFRS.

To many of the regulators, the standard setters and those of an economic, theoretical, or academic persuasion the Framework on which the standards are based and the thinking that emanates from this is the 'true way' – just believe the framework's thinking and all will be well.

It is easy to carp and criticise but would any of us like to devise and write them?

The Standards are being revised and developed and there are will be some shocks – further significant changes to practice are mooted, for example, on the accounting for leases and for long-term contract work in progress (construction contracts). For both of these topics some critics maintain that overly theoretical or impractical approaches to accounting are being suggested.

This may be the case but any new IFRS does go through a fairly lengthy and open development process with ample opportunity for comment.

Some issues are 'issues of the day', real or perceived issues arising in response to rogue accounting that most accountants would never contemplate. Thus content and demands of the standards can sometimes seem unbalanced.

Much accounting and disclosure will be redundant for straightforward businesses. The Standards (particularly those concerned with financial instruments) have to try to cover every eventuality arising from the 'clever' gamblers and other 'smart' business school alumni.

It is not the purpose of this text to rehearse the arguments for and against IFRS as it is today. However, we all need to be aware of the issues that prevent faster and more consistent adoption of IFRS and we all MUST understand the IFRS's already in existence.

Layout and how to use the book

Each chapter will contain the following sections:

A Key Points

What the Standard is about

B What is in the Standard

The list as set out in the actual Standard or Framework

C Why Needed

A brief explanation in simple terms of why a standard is needed

D Ideas – concepts

The accounting issues and any underlying concepts that have to be addressed

E Key Content of the Standard

The key content of the Standard – with explanation if needed

F Significant differences in GAAP

The main differences, if any, between IFRS, US and UK GAAP

How to use the book

- If you want to get a feel for what the Standards cover and issues to be addressed read A from each chapter.
- If you need to know more – scan section B and read C and D.
- For a more detailed understanding read E.
- If convergence with UK GAAP is an issue for you or you have to deal with financial statements produced under US GAAP read F.
- To use IFRS in practice you will have to access the IASB published documents – and possibly seek professional help.

Barriers to understanding

Terminology

A barrier to understanding accounting is the differing terminology and statement layouts commonly used. Whilst there has been some success in, for example, Standardising EU financial statement terminology and layouts (appropriately translated), there remains much diversity. Accounting Standards should drive further standardisation in the use of words and statement layout but different practices will remain. This is due to differences in custom, cultural differences or the sloppy use of English. For example: in the UK we say stock, in the US and under IFRS it would be inventory.

In this text the words from the Standards are used as far as possible, but common UK terminology is also frequently used. Thus profit & loss account is used as well as income statement; business or company, as well as entity.

Thought was given to using only the IFRS 'word' but in practice readers will need to contend with different terminology. The everyday words are often synonymous but there may be subtleties in different word usage.

Lesson: If in doubt check exactly how a word is being used.

Understanding financial statement and accounting practices

Further support can be found at the end of the book where there are review chapters covering:

- What balance sheets, profit and loss accounts (income or earnings statements) and cash flow statements aim to convey. The effect of the principal different national differences in components and layouts is explained.
- The use of financial statements as a basis or interpreting a business by carrying out ratio analysis is also outlined.

- An explanation of the need for and rationale behind accounting for and disclosure of financial instruments.
- Finally, the effect on analysis through distortions in accounting method and layout is demonstrated by examples of 'creative accounting' – although of course if accounting standards are based on clear principles there should be little room for interpreting how they should be applied.

Order of chapters

The majority of Accounting Standards were issued and have often been re-issued in response to an event – a significant lapse in proper accounting and disclosure. Thus the chronological or numerical order of the Standards follows little logic (in any event it is questionable as to whether academics or practitioners could agree to a logical order). The history of the development of individual Accounting Standards often illustrates why Standards are needed.

The Standards are dealt with in the following groupings, the aim being to make the study of the Accounting Standards more coherent. If a particular Standard or issue has to be understood then the table below or the contents list should lead the reader to the topic.

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Summary objectives and requirements of the Standards

Financial statements, Accounting policies and other disclosure issues

IAS 1 – Presentation of financial statements

Financial statements should have standard minimum content and the basis upon which the figures are prepared should be explained.

The Standard sets out the minimum contents of financial statements: balance sheet, income statement, cash flow statement, significant accounting policies, statement of changes in equity and supporting notes where appropriate.

The Standard reiterates the fundamental accounting concepts of going concern and accruals and their place in the accounting framework.

IAS 8 – Accounting policies, changes in accounting estimates and errors

There needs to be clear criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. The Standard is intended to enhance the relevance, reliability and comparability of an entity's financial statements.

Disclosures (of significant information)

IAS 10 – Events occurring after the balance sheet date

Events may affect a company after the year's end but before accounts are 'signed off'. Events may not cause change to figures in the financial statements, however, to ignore them may be misleading to users of the financial statements.

The Standard requires that significant events after the balance sheet date should be reported by way of note(s) to the accounts.

IAS 24 – Related party disclosures

Who really owns and controls the business? This is vital information if all those involved with the business are to be treated fairly.

The Standard requires disclosure of who really owns and controls the business (related parties) along with details of transactions and balances between the business and these related parties.

IFRS 1 – First time application of IAS's

Businesses adopting IFRS's should comply with them. The Standard requires an entity to use the same (IFRS compliant) accounting policies in its opening IFRS balance sheet and throughout all periods presented in its first IFRS financial statements.

IAS 34 – Interim financial reporting

Interim financial reports must contain a minimum amount of reliable information.

The Standard requires that interim financial statements should contain the same individual reports and use the same accounting policies as the annual statutory accounts. It may be practical and acceptable to demand less detail in some of the disclosures and notes.

The Standard requires the disclosure of material one-off items, including the costs of discontinuing operations. Non-current (fixed) assets that are to be sold should be disclosed separately in the balance sheet.

Profit & Loss Account – Income Statement

IAS 18 – Revenue

The primary issue in accounting for revenue is determining when to recognise revenue – when sales have been irrevocably earned.

The Standard requires that revenue only be recognised when quantifiable inflows (of cash) will definitely occur. The Standard identifies the circumstances by which these criteria will be met and, therefore, revenue can

be recognised. It also provides practical guidance on the application of the criteria.

IAS 21 – The effects of changes in foreign exchange rates

Currency gains and losses can be realised or unrealised, many different rates could be used for translation purposes, and gains or losses could be shown in different places in the accounts.

The Standard requires that transactions should be translated at the rate ruling at the date of the transaction. Balance sheet figures should be translated at the rate ruling at the balance sheet date. For non-monetary assets and liabilities the historical rate should be used.

IAS 19 – Employee benefits

The cost of employee benefits to a business should be disclosed, particularly the cost of pension liabilities.

The Standard requires disclosure of all significant classes of employee benefits, but particularly pension contributions. The Standard requires disclosure of contributions to both defined contribution and defined benefit schemes. For defined benefit schemes the adequacy of funding has to be calculated and any liability due to under-funding disclosed.

IFRS 2 – Shared Based Payment

Entities often grant shares or share options to employees or other parties. Without calculation of the cost of the payment and full disclosure of long-term effects such payments may appear 'free'. Awarding shares or share options means that a portion of the value of the company is being given away.

The Standard requires that a value is put on the cost of awarding share based payments and that the cost is recognised immediately in profit and loss.

IAS 23 – Borrowing costs

Borrowing costs relate to funding businesses and should be charged against income as incurred. However, fixed assets often require considerable funds to finance their construction. Borrowing or interest costs may be considered a cost specifically incurred to bring the asset into revenue earning condition – under strict conditions the costs may be capitalised.

The Standard requires that borrowing costs should be capitalised (included as a cost of the fixed asset) when they are directly attributable to the acquisition, construction or production of a fixed asset.

IAS 20 – Accounting for government grants

Grants may be given to support day-to-day operations – revenue, or to encourage investment in fixed assets – capital. The correct classification is important.

The Standard requires the correct matching of grant credits either as revenue items or capital items. Specifically, capital grants (for equipment etc.) should be spread over the life of the asset and not taken as income.

IAS 12 – Income taxes/current tax/deferred tax

An explanation of the bases for tax charges or credits and where they are recognised in the financial statements is needed. Provision should be made for future tax liabilities that will arise on the reversal of timing differences between accounts and tax charges.

The Standard requires an explanation of the relationship between tax expense or income and accounting profit. It also requires an explanation of changes in the applicable tax rate(s) compared with the previous accounting period.

The Standard requires that a deferred tax liability should be recognised for all taxable temporary differences and charged to the income statement. A deferred tax asset should be recognised to the extent that it is probable that taxable profit will be available in the future against which to recover tax or reduce liability.

IFRS 5 – Non-current assets held for sale and discontinued operations

Profits and losses should generally be taken to the income statement with any large one-off items disclosed separately, particularly the effects of discontinuing operations.

The Standard requires the disclosure of material one-off items, including the costs of discontinuing operations. Non-current (fixed) assets that are to be sold should be disclosed separately in the balance sheet. Also the reporting of errors or alterations to the figures due to changes in accounting policies should be disclosed.

IAS 33 – Earnings per share

An earnings per share ratio is considered an important ratio. If there was no clear definition then this ratio could be misrepresented.

This Standard prescribes the basis for calculating and presenting earnings and other amounts per share in the financial statements of publicly quoted entities.

Balance Sheet

IAS 16 – Property plant and equipment

Tangible fixed assets are a major part of capital employed for the many businesses. They should be carried at cost, or if revalued then this should be done so on a consistent basis.

The Standard codifies much of existing accounting practice. Assets may be carried at cost or revalued. Fixed assets (except land) should be depreciated over reasonable periods.

IAS 40 – Investment property

Investment properties are held for gain, not consumption. It is inappropriate to depreciate them, but they should be revalued to up-to-date fair value.

The Standard requires that investment properties should not be depreciated but shown at fair value.

IAS 38 – Intangible assets

Intangible assets are important for many businesses and in spite of difficulties in valuing them they should be recognised in the balance sheet as assets at cost. The cost should be amortised over reasonable periods or checked annually for impairment in value.

The Standard requires that purchased goodwill and intangible assets are capitalised at cost but reviewed annually for impairment. Own generated intangibles such as brands, patents etc. must not be capitalised in the balance sheet.

IAS 36 – Impairment of assets

There is a need to have some 'science' to ensure assets carried in the balance sheet at fair value have not lost value due to changes in economic circumstances. This Standard aims to provide the framework for prudently valuing goodwill, intangibles and also tangible fixed assets.

The Standard requires a review for impairment of a fixed asset or goodwill to be carried out if events, or changes in circumstances, indicate that the carrying amount of the fixed asset or goodwill may not be recoverable.

Then if, and only if, the recoverable amount of an asset is less than its carrying amount, its carrying amount should be reduced to its recoverable amount. The resultant impairment loss should be recognised in the income statement or against any previous revaluation of the same asset.

IAS 2 – Inventories/stock

Stock and short-term work in progress values are critical to the reporting of profits or losses at the correct amount and in the correct period. Clear definition of terms and defined accounting is required.

The Standard requires that inventories/stock be valued at cost or net realisable value. The method of measuring stock should be to value each item at historical cost, or as close an approximation as is possible.

IAS 11 – Construction contracts/Long-term WIP

The valuation of construction contracts or long-term work in progress is critical to the reporting of balance sheet values and profits or losses – definition of terms and defined accounting is required.

The Standard requires that when the outcome of a construction contract can be estimated with reasonable reliability, revenue and costs should be recognised by reference to the stage of construction. If it is probable that total costs will exceed total revenue, the expected contract loss should be recognised as an expense immediately. The amounts of revenue from contracts and the method of recognising this revenue should be disclosed.

IAS 17 – Leases

The substance of what is going on in business is more important than simply reporting the legal form of transactions. A commitment to make payments for a number of years for the use of an asset means you effectively own the asset BUT also have the contra liability.

The Standard requires that leased, hired or rented assets should be shown as assets of the lessee along with the related liability – the obligation to make lease payments.

IAS 37 – Provisions, contingent liabilities and contingent assets

Provisions should be made only when there is certainty of a future liability. Other potential but nebulous liabilities (or assets) should be quantified and disclosed as contingent liabilities.

The Standard accepts the business and commercial need for provisions but brings definition as to when and how provisions should be sanctioned. The Standard demands a high degree of certainty as to cause and amount before provisions can be made.

Cash flow statements

IAS 7 – Statement of cash flows

Cash flow statements should present the business from the perspective of how it generates and consumes cash and how it is funded.

The Standard requires disclosure of historical changes in cash and cash equivalents of an enterprise by means of a statement which classifies cash flows in and out during the period that arise from operating, investing and financing activities.

Financial Instruments

IAS 32 – Financial instruments: Disclosure and presentation

IAS 39 – Financial Instruments: Recognition and measurement

IFRS 7 – Financial Instruments: Disclosures

What is debt (loans) and what is equity (risk capital)? What financial risk has a business entered into by dealing in derivatives – hedges, futures etc?

The Standards aim to define what is not equity. The Standards require disclosure of information that can help identify the risks a business has in respect of financial instruments. Where possible financial assets should be revalued to fair value at the balance sheet date. Hedging (netting of gains and losses) is allowed under strict conditions.

Accounting for groups and investments

IFRS 3 – Business combinations

IAS 27 – Consolidated and separate financial statements

Businesses acquire other businesses – acquisitions. The difference between purchase price and fair value of assets acquired is goodwill which should be disclosed in the balance sheet of the group, carried at cost, but tested each year for any impairment.

The Standards imply that acquisition accounting with the calculation and disclosure of goodwill should be the norm. Consolidated group accounts should be produced. Merger accounting is prohibited.

The Standards aim to define at what date an acquisition should be accounted for. Values used should be fair values and any resulting goodwill should be carried at cost, tested for impairment but NOT written off over a number of years.

IAS 28 – Accounting for investments in associates

IAS 31 – Financial reporting of interests in joint ventures

A company could own 1%, 14%, 38% etc. of another company. The issue is how should the net assets and results of these different levels of ownership be accounted for? Definition is needed for the varying levels of investment and control.

The Standards define the treatment of a business's investments in other companies. There needs to be a clear and consistently applied distinction between control (a subsidiary) and other levels of investment and influence on the owned entity.

IFRS 8 – Operating Segments

An important use of financial statements is to identify performance and the amount of, and existence of, assets and liabilities. An analysis of the overall picture is required.

The Standard aims to assist analysis of a diverse group's business activities by requiring a breakdown of key figures in the balance sheet and income statement on the same basis as executives use for decision making purposes.

Specialised industries

IAS 26 – Accounting and reporting by retirement benefit plans

Employees (prospective pensioners) and existing pensioners need to know whether a business's pension scheme is adequately funded. The accounts of such funds should clearly and fairly state the basis on which assets and liabilities are recognised and valued in the scheme's balance sheet.

The Standard requires the following disclosures:

- For a defined contributions scheme a statement of the funding policy, a summary of significant accounting policies and net assets available for benefits.
- For defined benefit plans a statement of net assets available for benefits and the actuarial present value of promised retirement benefits and thus the resulting surplus or deficit of the plan's fund.

IAS 41 – Agriculture

Agriculture is a specialised area of business and thus accounting is specialised. An issue is the valuation of livestock and crops.

The Standard requires that a biological asset should be measured on initial recognition and thereafter at its fair value, and appropriate accounting policies should be disclosed.

IFRS 4 – Insurance Contracts

Accounting practices for insurance contracts have been diverse, and have often differed from practices in other sectors. This standard is a first phase aimed at improving accounting for insurance and requiring disclosure of information about such contracts. The approach of this initial standard covering insurance contracts is to align accounting with that set out in the IFRS framework, prohibit what is unacceptable practice and move accounting policies and disclosure towards what is considered best practice.

The three principal aims of the Standards are to:

- Improve accounting policies and ensure they align with the Framework.
- Carry out liability adequacy tests and if there is a shortfall the entire amount should be recognised as a charge in profit and loss.
- Require disclosure about the amount, timing and uncertainty of future cash flows.

IFRS 6 – Exploration for and evaluation of mineral resources

There are differing views as to how exploration and evaluation expenditures should be accounted for. Thus there is the need for a single acceptable approach, consistent with the IFRS framework and other existing IFRS's.

The Standard gives general guidance, permitting capitalisation of expenses associated with exploring and evaluating mineral resources. It permits existing accounting policies to be continued but does point to possibly improved disclosure. It specifically requires that any expenses capitalised as assets should be subject to impairment reviews and gives outline examples of signs of impairment.

Other

IAS 29 – Financial reporting in hyper inflationary economies

Economies can be subject to periods of hyperinflation. The problem is how to meaningfully report business results.

The Standard requires that figures for the period in question should be adjusted as at the year end balance sheet date, either by adjusting the historic cost figures with indices that adjust to the measuring unit (or currency), or by adjusting relevant balance sheet and earnings statement figures to current cost.

2
The Framework, financial statements, accounting concepts and policies

IASB Framework

A Key points

The framework aims to answer:

- Is a (theoretical) base from which standards can be compiled needed?
- For whom are accounts prepared?
- What valuation – measurement bases are to be used for assets?
- What are 'fundamental' concepts?

B What is in the Framework?

Quite a list!

C Why needed – why have a Framework?

The Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The Framework has been developed so that it is applicable to a range of accounting models and concepts of capital and capital maintenance. The ideas in the Framework are shared by US – FASB (Financial Accounting Standards Board) -Concepts Statements

D Ideas – concepts

What is the prime purpose of financial statements?

Accounts or financial statements are considered by many as simply a record of what has happened. If the statements are audited – it is a substantiated record of what has happened. They may be accepted as a record of what is owned and has been managed. For many they do give indications of performance – profits made and of worth – the balance

sheet assets and liabilities. Many users are not really interested in them – they are history.

What do the standard setters see as the prime reason for producing financial statements?

For many accountants and users of accounts the reason stated by the Board of the IASC might seem rather fanciful or grandiose:

> *"The Board of IASC believes that financial statements are prepared for the purpose of providing information that is useful in making economic decisions."*

This stated principal purpose underlies the entire drift of accounting standard development over the years. Accounting – producing accounts was (and is) a practical subject. Book keeping is not easy to learn and grasp but practice helps.

Why the emphasis on "useful in making economic decisions"?

One reason, which the academics will undoubtedly dispute, is that the development of Further Education from the 1960's onwards meant that new subjects were needed for the new universities – in the UK, US, Australia and elsewhere. There were few professors, doctors etc of accounting. Accounting and book keeping were subjects for 'Nite' school. So enter the economists or those of such a mind. Some would say that economics is a black art – "the dismal science" (well Thomas Carlyle did). Academic rigor and depth were brought to a basic skill and the accounting has never looked back!

Regardless of the rationale for the declared objectives in the Framework it is very important if you wish to comprehend the mind set of the standard setters as manifested in the Framework as the thinking and definitions pervade the IFRS's.

E Key Content of the Standard

Scope

The Framework deals with:

a) the objective of financial statements;

b) the qualitative characteristics that determine the usefulness of information in financial statements;

c) the definition, recognition and measurement of the elements from which financial statements are constructed; and

d) concepts of capital and capital maintenance.

Fundamental or 'Bedrock' Concepts and desirable qualities

The underlying assumptions, fundamental concepts or also 'bedrock' concepts are those we have known and used for years:

Accrual basis

In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not when cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going concern

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the

need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Desirable Qualities

What a 'concept', 'a notion' or a 'desirable quality' is may be clear to the standard setters but it can be confusing to those who have to apply the standards. For example, the framework lists qualitative characteristics of financial statements in an order, but then states that the four principal qualitative characteristics are understandability, relevance, reliability and comparability. I would have said that "substance over form" is a 'concept' and pretty fundamental too!

Qualitative characteristics of financial statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

The following is a list of the terminology/definitions contained in the IASB Framework.

- Understandability
- Relevance
- Materiality
- Reliability
- Faithful Representation
- Substance over form
- Neutrality
- Completeness
- Comparability

The words generally have their normal every day usage meanings but Substance over Form may need more explanation:

Substance over form

The Framework describes substance over form as follows:

> *"If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction)."*

For many companies large and small a common example is when a car is leased or 'contract-hired' from new for a three year period then handed back or purchased for some agreed figure. The legal form is that the car is owned by the finance house but the economic reality is that the company 'owns' the car for the best part of its economic life. The first 3 years of ownership is a significant part of the cars useful life and when most value is consumed. Although ignored by many companies large and small the car should be recognised as a tangible fixed asset and a liability for the payments to the finance house recognised under current and long-term liabilities.

An example of crass abuse of the concept of substance over form was the Enron scandal – in this case hiding assets and more importantly liabilities off the balance sheet.

Finally – PFI – future liabilities – no matter what ones views on the politics of Private Finance Initiative (PFI) contracts they have achieved UK and international acceptance as a means of satisfying demand for public assets and services. The greatest problem with PFI projects is the determination of whether or not they pass risk from the Treasury (tax payer) to third parties. It has been possible to define events and related cash flows in such a way that a contract was definitely "off balance sheet",

that is neither an asset of nor a corresponding liability of the Treasury (the taxpayer) – there are non-existent assets (and liabilities)!

The issue of leasing and related situations is very likely to be tightened up with the issue of a new IFRS in 2011.

Content of financial statements

The framework covers the need for and content of balance sheets (position statements), performance (P&L or income statements) and cash flow statements. It then defines the principal issues that have to be addressed (the issues that are covered in each accounting standard).

Asset and liability definitions

Below are definitions of assets and liabilities and examples of what most would understand as such.

Assets

"Many assets, for example, property, plant and equipment, have a physical form."

Liabilities

"The acquisition of goods and the use of services give rise to trade payables."

The Framework definitions are more complex, in 'economist speak' and aim to be rigorous:

*"An **asset** 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."*

*"A **liability** is 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."*

The framework concedes: *"The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria*

that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition… In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion before an asset or liability is recognised."

However assets and liabilities MAY be recognised although in strict legal terms no assets or liability is owned or owed: *"In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form."* This is the concept of 'substance over form' and can be seen in action in accounting for leases.

It will thus be evident that **Recognition** is a very important issue and indeed early on in every IFRS there is a section on the Recognition criteria for the asset/liability/income/expense being considered.

> *"Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals. Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material."*

Measurement

A defect of simple book keeping is that it records transactions on a historic and legalistic basis. In every IFRS there is a section on the Measurement method(s) for the asset/liability/income/expense being considered.

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.

A number of measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

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. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The framework does not specifically highlight **Disclosure** as an important issue BUT it does go on about the concepts of capital.

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

Concepts of capital

A financial concept of capital is adopted by most entities in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous

with the net assets or equity of the entity. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

The concepts of capital give rise to the following concepts of capital maintenance:

> **Financial capital maintenance**. Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.
>
> **Physical capital maintenance**. Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

F Significant differences in GAAP

US GAAP

The FASB Concepts Statements are similar to the IASB Framework but are non-authoritative.

IFRS uses the Framework as a point of reference to the FASB the framework is non-authoritative guidance.

The concept of 'substance over form' is not entrenched in the FASB Concepts.

UK GAAP

UK GAAP is not based on a framework as such.

Many of the concepts are similar.

3
Presentation of financial statements – IAS 1

A Key Points

- Financial statements should have standard minimum content.
- The base upon which the figures are prepared should be explained.
- The Standard reiterates the fundamental accounting concepts of going concern and accruals.
- The Standard also defines or discusses common accounting ideas such as materiality and the use of estimates.

B What does the IAS contain?

C Why needed

What should a set of Financial Statements contain? There will be differing views as to what the essential statements are and how they should be laid out. This Standard lists the essential elements of a set of financial statements.

Also businesses must have clearly stated accounting policies (rules) if financial statements are to be read or interpreted clearly. Figures are meaningless if not prepared on a defined base. Accounting concepts such as 'going concern' and 'accruals' are considered fundamental or 'bedrock'. These and other concepts are defined and explained. If there were no rules then creative accounting might follow!

D Ideas – concepts

Financial statements could contain endless statements, data and explanations. What is required is a practical minimum number of statements and narrative that permit a fair understanding of the financial results, cash flows and state of a business for a defined period.

A complete set of financial statements is considered to comprise:

- a balance sheet
- an income statement (P&L account)
- a statement of cash flows
- accounting policies and explanatory notes
- a statement of changes in equity – all changes in equity or at least the changes that arise from capital transactions other than those with owners, e.g. revaluation gains.

Statements of cash flows, their content and layout can be found in IAS 7.

A statement of changes in equity should show all items that affect total shareholders' equity. That is profit or loss for the period, other gains or losses, adjustments due to changes in accounting policies, capital trans-

actions with the owners, e.g. dividend payments or capital introduced. For many companies this is a very straightforward statement – opening amount, add profit for year less dividends gives closing amount.

Accounting policies define the process whereby transactions and other events are reflected in financial statements. Figures are meaningless if not prepared on a defined base. Accounting concepts such as 'going concern' and 'accruals' are considered fundamental or 'bedrock'. Other concepts and desirable qualities and their application, are considered in this Standard or the IASB Framework. Accounting policies set out the particular ways in which concepts are applied to separate items in the financial statements.

For example, an accounting policy for a particular type of expenditure may specify whether an asset or an expense is to be recognised; the basis on which it is to be measured; and where in the balance sheet or income statement it is to be presented.

The two fundamental or 'bedrock' concepts

Going concern

The preparer (and auditor) of the accounts should consider and check whether or not the enterprise is likely to continue in operational existence for the foreseeable future. This means, in particular, that there is no intention or necessity to liquidate or curtail significantly the scale of operations, and thus the balance sheet and income statement will not be materially affected.

The concept also requires the preparer (and auditor) to consider and check that the business is likely to have cash/bank resources sufficient to remain in business for the foreseeable future – 'foreseeable future' is considered by auditing Standards to be a period of at least twelve months beyond the date of signing the financial statements. When financial statements cannot be prepared on a going concern basis, then that fact should be disclosed.

Accruals or matching concept

Revenue and costs should be accrued (that is, recognised as they are earned or incurred, not as money is received or paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the income statement of the period to which they relate.

E Key Content of the Standard

Objective

This Standard prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

Definitions

General purpose financial statements (referred to as 'financial statements') are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

Impracticable. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

International Financial Reporting Standards (IFRSs) are Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise:

a) International Financial Reporting Standards;

b) International Accounting Standards; and

c) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

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. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Notes contain information in addition to that presented in the statement of financial position, statement of comprehensive income, separate income statement (if presented), statement of changes in equity and statement of cash flows.

Other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs.

Owners are holders of instruments classified as equity.

Profit or loss is the total of income less expenses, excluding the components of other comprehensive income.

Reclassification adjustments are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or previous periods.

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.

10 A complete set of financial statements comprises:

a) a statement of financial position as at the end of the period;

b) a statement of comprehensive income for the period;

c) a statement of changes in equity for the period;

d) a statement of cash flows for the period;

e) notes, comprising a summary of significant accounting policies and other explanatory information; and

f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

An entity may use titles for the statements other than those used in this Standard.

11 An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.

Going concern

25 When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern.

Accrual basis of accounting

27 An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

Materiality and aggregation

29 An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.

Structure – notes

112 The notes shall:

a) present information about the basis of preparation of the financial statements and the specific accounting policies used.

b) disclose the information required by IFRSs that is not presented elsewhere in the financial statements; and

c) provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

Disclosure of accounting policies

117 An entity shall disclose in the summary of significant accounting policies:

a) the measurement basis (or bases) used in preparing the financial statements, and

b) the other accounting policies used that are relevant to an understanding of the financial statements.

An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies.

Sources of estimation uncertainty

122 An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements that management has made in the process of applying the entity's accounting policies.

125 An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Capital

134 An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

F Significant differences in GAAP

US GAAP

Fair presentation

Under US GAAP the objective of financial statements is fair presentation in accordance with U.S. GAAP, whereas the overriding requirement of IFRSs is for the financial statements to give a fair presentation (or true and fair view as in the UK).

Substance over form

Under US GAAP there is no general principle that transactions should be accounted for in accordance with their substance, rather than only their legal form. Under IFRS transactions should be accounted for in accordance with their substance, rather than only their legal form.

Gains or losses recognised in equity

Under US GAAP all items recognised directly in equity as a component of accumulated other comprehensive income are recycled to profit or loss.

Under IFRS a gain or loss may be recognised directly in equity only when a standard or interpretation permits or requires it. Also some of the gains or losses recognised directly in equity are never recycled to profit or loss.

UK GAAP

Formats

UK accounts format is set out in the Companies Acts – these do permit or require the use of IFRS.

Purpose of financial statements

A continuing difference under UK GAAP is there is less emphasis on the purpose of financial statements to be useful in making economic decisions. The use of statements for stewardship is seen as being very important.

4
Accounting policies changes in accounting estimates and errors – IAS 8

A Key points

- How assets/liabilities and income/expenses are accounted for is very important.
- The application of IFRS, any rules, concepts or conventions should be clearly explained.
- Accounting policies are key to understanding the numbers.
- Disclosure should be made of the use and application of material estimates and any underlying judgments.

B What does the IAS contain?

- ERRORS 41–49
- IMPRACTICABILITY IN RESPECT OF RETROSPECTIVE APPLICATION AND RETROSPECTIVE RESTATEMENT 50–53

C Why needed

Comprehending accounting methods and policies is fundamental if the numbers are to be properly understood and interpreted.

Where material the use of estimates and judgments should be explained.

If current or comparative errors have been made there needs to be consistency on their treatment and disclosure – mistakes do happen!

D Ideas – concepts

The idea of this standard is simply to ensure thoughtful, compliant and full disclosure of accounting policies. The basis (if not based on IFRS) for accounting polices should be explained as should the use of estimates and judgments.

This IAS ties in so closely with IAS 1 and it is a pity that they are not combined.

E Key Content of the Standard

Objective

The objective of this Standard is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. The Standard is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the

financial statements of other entities. Disclosure requirements for accounting policies, except those for changes in accounting policies, are set out in IAS 1.

Definitions

Accounting policies are the specific principles, bases, conventions, rules and practices applied 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.

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:

a) was available when financial statements for those periods were authorised for issue; and

b) 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:

a) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and

b) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The Framework for the Preparation and Presentation of Financial Statements states in paragraph 25 that *"users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence."*

Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

Required Practice

Selection and application of accounting policies

7 When an IFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS.

10 In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:

a) relevant to the economic decision-making needs of users; and

b) reliable, in that the financial statements:

i) represent faithfully the financial position, financial performance and cash flows of the entity;

ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

iii) are neutral, i.e. free from bias;

iv) are prudent; and

v) are complete in all material respects.

11 In making the judgements described above in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

a) the requirements in IFRSs dealing with similar and related issues; and

b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.

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

Consistency of accounting policies

13 An entity shall select and apply its accounting policies 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 such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

F Significant differences in GAAP

US GAAP

There are no significant differences in approach.

However unlike IFRSs, errors must be corrected by restating opening equity and comparatives – there is no 'impracticality' exemption. But presumably not if the error is immaterial.

UK GAAP

Again there are no significant differences in approach.

5
Events after the reporting period – IAS 10

A Key points

- Life goes on after a balance sheet date.
- What happens between a year end and signing off of accounts may have a significant effect on the year end figures or the future of a business.

This Standard requires:

- Reassessment of past figures – adjusting accounts figures where more accurate evidence is available.
- Disclosure of events that do not change past figures but do affect the future of the business.

B What does the IAS contain?

C Why needed

Events may affect a company after the year end but before accounts are 'signed off'. Although these may not cause change to figures in the accounts not acknowledging their existence (by way of a note to the accounts) could be quite misleading.

D Ideas – concepts

This obvious concept is that accounts should reflect all information available up to the date of sign off. If you obtain information that changes subjective views taken on figures in accounts after the balance sheet date, but before accounts are issued, then the account figures should be adjusted. These are adjusting events.

However, if some significant information is obtained, or event occurs that does not affect the historic figure shown in the financial statements but that will affect the current or future periods then this should be reported. These are non-adjusting events. For example, a company's premises that are in the balance sheet at 1m at the year end date of 31 December, are burnt to the ground on 4 February of the following year – the premises did exist at the balance sheet date and were worth 1m – but not now! This significant fact should be disclosed.

E Key Content of the Standard

Objective

The objective of this Standard is to prescribe:

a) when an entity should adjust its financial statements for events after the reporting period; and

b) the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.

The Standard also requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is not appropriate.

Definitions

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. Two types of events can be identified:

a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

Required Practice

8 An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.

10 An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.

14 An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

F Significant differences in GAAP

US GAAP

The general principles are similar.

Generally financial statements are not adjusted for events that are indicative of conditions that arose after the reporting date. IFRS does require adjustment if the going concern concept is not applicable (IAS 10, 14 to16).

The period to consider goes beyond the date of authorisation of the financial statements to the date that the statements are issued.

US GAAP SEC registrants should adjust the balance sheet for a share dividend, share split or reverse share split occurring after the reporting date.

Post-reporting date refinancing is considered in determining the classification of debt at the reporting date under IFRS there would be no re-classification.

In certain circumstances liabilities due to violations of covenant and payable in demand at the reporting date may be classified as non-current.

UK GAAP

UK FRS 21 is based on IAS 10 (revised 2003).

6
Related party disclosures – IAS 24

A Key Points

- Businesses often have significant or powerful; investors, suppliers, customers, officers etc.
- These people can influence the business.
- If these people are 'related' then they may not act as those at arms length act.
- The names and details of such relationships should be disclosed.

B What does the IAS contain?

C Why needed

- Who really owns and controls the business?
- Do owners (or their families) and those in authority and with power in the business, have personal deals with the business?

The above information is important if all those involved with the business are to be treated fairly.

D Ideas – concepts

Users of accounts must know if any of those involved in running the business have 'interests' in the business. That is, do they have control to a greater or lesser degree over the business? Do they also either directly or through a close relationship have (favourable) dealings with the business? This Standard is all about disclosure.

E Key Content of the Standard

Objective

1 The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

Definitions

Related party. A party is related to an entity if:

a) directly, or indirectly through one or more intermediaries, the party:

i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

ii) has an interest in the entity that gives it significant influence over the entity; or

iii) has joint control over the entity;

b) the party is an associate (as defined in IAS 28 Investments in Associates) of the entity;

c) the party is a joint venture in which the entity is a venturer (see IAS 31 Interests in Joint Ventures);

d) the party is a member of the key management personnel of the entity or its parent;

e) the party is a close member of the family of any individual referred to in (a) or (d);

f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

a) the individual's domestic partner and children;

b) children of the individual's domestic partner; and

c) dependants of the individual or the individual's domestic partner.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Joint control is the contractually agreed sharing of control over an economic activity.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement.

Required Practice

DISCLOSURE

13 Relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been transactions between them. An entity shall disclose the name of its parent and, if different, the ultimate controlling party.

17 An entity shall disclose key management personnel compensation in total and for each of the following categories:

a) short-term employee benefits;

b) post-employment benefits;

c) other long-term benefits;

d) termination benefits; and

e) share-based payment.

18 If there have been transactions between related parties, an entity shall disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements.

F Significant differences in GAAP

US GAAP

Key management compensation is not required to be disclosed.

UK GAAP

Disclosure of key management compensation is not required.

Particulars of transactions between two or more members of a group need not be given, provided that any such member is wholly owned within the group.

7
First-time adoption of IFRS – IFRS 1

A Key Points

- Moving from another GAAP system to IFRS is inevitably a significant change.
- The process and explanation of the move should be fully disclosed in a consistent manner.

B What does the IAS contain?

C Why needed

International Accounting Standards may be quite different from other GAAP. Some industry results will be much more affected than others. The main thrust of this first IFRS is that adoption should not be impossible because of the time or cost required in dealing with every nuance of the Standards.

D Ideas – concepts

Standards should be complied with – but the introduction should not be hindered by undue expense or time required for compliance.

E Key Content of the Standard

Objective

The objective of this IFRS is to ensure that an entity's first IFRS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that:

a) is transparent for users and comparable over all periods presented;

b) provides a suitable starting point for accounting in accordance with International Financial Reporting Standards (IFRSs); and

c) can be generated at a cost that does not exceed the benefits.

Definitions

Date of transition to IFRSs is the beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS financial statements.

Deemed cost is an amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

First IFRS financial statements are the first annual financial statements in which an entity adopts IFRS by an explicit and unreserved statement of compliance with IFRSs.

First IFRS reporting period is the latest reporting period covered by an entity's first IFRS financial statements.

First-time adopter is an entity that presents its first IFRS financial statements.

Opening IFRS statement of financial position is an entity's statement of financial position at the date of transition to IFRSs.

Previous GAAP is the basis of accounting that a first-time adopter used immediately before adopting IFRSs.

Required Practice

7 An entity shall use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements.

23 An entity shall explain how the transition from previous GAAP to IFRSs affected its reported financial position, financial performance and cash flows

Problems areas and questions to ask about the accounts

The time needed

Even for a straightforward business there is a lot of work to do. The first year is not the year of change but earlier if reliable comparatives are to be given.

Is the explanation of the transition adequate?

Businesses adopting IFRS's should comply with them

The Standard requires that an entity to use the same (IFRS compliant) accounting policies in its opening IFRS balance sheet and throughout all periods presented in its first IFRS financial statements.

F Significant differences in GAAP

A unique IFRS. Its relevance will wane as convergence progresses.

8
Interim financial reporting – IAS 34

A Key Points

- Interim financial statements are important for investors and all who have an interest in the progress of a business.
- Interim figures should be compiled and presented in a manner consistent with full year figures.

B What does the IAS contain?

C Why needed

Listed companies, as a matter of good governance and because of stock market listing requirements will report half yearly and even quarterly. This Standard is another where the other demands for reporting and disclosure would seem to make the need for a Standard superfluous.

D Ideas – concepts

Interim financial statements should contain the same individual reports and use the same accounting policies as the annual statutory accounts. It may be acceptable and practical to demand less detail in some of the disclosures and notes.

Objective

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

Definitions

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements (as described in IAS 1 Presentation of Financial Statements (as revised in 2007)) or a set of condensed financial statements (as described in this standard) for an interim period.

Required Practice

CONTENT OF AN INTERIM FINANCIAL REPORT

Minimum components of an interim financial report

8 An interim financial report shall include, at a minimum, the following components:

a) a condensed statement of financial position;

b) a condensed statement of comprehensive income, presented as either;

i) a condensed single statement; or

ii) a condensed separate income statement and a condensed statement of comprehensive income;

c) a condensed statement of changes in equity;

d) a condensed statement of cash flows; and

e) selected explanatory notes.

Selected explanatory notes

16 An entity shall include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis. However, the entity shall also disclose any events or transactions that are material to an understanding of the current interim period:

a) a statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change;

b) explanatory comments about the seasonality or cyclicality of interim operations;

c) the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence;

d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;

e) issuances, repurchases, and repayments of debt and equity securities;

f) dividends paid (aggregate or per share) separately for ordinary shares and other shares;

Disclosure of segment information is required in an entity's interim financial report only if IFRS. 8 Operating Segments requires that entity to disclose segment information in its annual financial statements.

Disclosure of compliance with IFRSs

19 If an entity's interim financial report is in compliance with this Standard, that fact shall be disclosed. An interim financial report shall not be described as complying with IFRSs unless it complies with all the requirements of IFRSs.

Materiality

23 In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality shall be assessed in relation to the interim period financial data. In

making assessments of materiality, it shall be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

DISCLOSURE IN ANNUAL FINANCIAL STATEMENTS

26 If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate shall be disclosed in a note to the annual financial statements for that financial year.

Same accounting policies as annual

28 An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis.

Revenues received seasonally, cyclically, or occasionally

37 Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year.

Costs incurred unevenly during the financial year

39 Costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

Use of estimates

41 The measurement procedures to be followed in an interim financial report shall be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.

F Significant differences in GAAP

US GAAP

Under US GAAP each interim period is viewed as an integral part of an annual period to which it relates. Under IFRS each interim period is viewed as a discrete period in determining the recognition and measurement of elements of the financial statements. This can lead to issues as to whether interim impairments might be reversed at the year end.

IFRIC Interpretation 10 – Interim Financial Reporting and Impairment gives further guidance on the issue of impairment adjustments.

Under US GAAP a condensed statement of changes in equity is not required but is under IFRS.

UK GAAP

There is no UK FRS. But the Statement by the Accounting Standards Board – Half-yearly financial reports (issued July 2007) gives guidance.

9
Revenue – IAS 18

A Key Points

- Does revenue = sales?
- Whatever called – revenue or sales – has income really been earned?
- There are varying conventions as to how sales are 'booked'.
- The Standard sets out when sales or revenue should be recognised.
- The Standard focuses on the contractual point of sale.

B What does the IAS contain?

C Why needed

Revenue (income, sales or turnover, there are many terms used) is the life blood of business. All businesses want more! For cash sales in a shop the revenue earned is clear, or is it? Even there, there might be a history of returned goods which, 'as the customer is always right' will give rise to refunds. So when is revenue accurately determined and irrevocably earned? – That is the question.

The primary issues in accounting for revenue are the correct classification of credits as income and the timing of recognition. The definition in the Accounting Standard does not really help, it merely states the obvious. "*Revenue is recognised when it is probable that future economic benefits will flow to the enterprise and these benefits can be measured reliably*." This Standard does go on to identify the circumstances under which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria. Income recognition should be neither inappropriately deferred nor, what is more prevalent, anticipated.

D Ideas – concepts

Revenue (income or sales) and the resultant profit or earnings are vital figures when reporting a business' progress. There will always be pressure to show the highest, most favourable revenue and profit position.

The fundamental or bedrock concept of accruals demands that revenue and costs be properly matched within the time period being reported upon. There must be clear rules on what the genuine revenue earned in any accounting period is.

E Key Content of the Standard

Objective

Income is defined in the Framework for the Preparation and Presentation of Financial Statements as 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. Income encompasses both revenue and gains. Revenue is income that arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends and royalties.

The objective of this Standard is to prescribe the accounting treatment of revenue arising from certain types of transactions and events. The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. This standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

Definitions

Revenue is 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.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Required Practice

MEASUREMENT OF REVENUE 9–12

9 Revenue shall be measured at the fair value of the consideration received or receivable.

10 The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

In most cases the fair value is the cash immediately or ultimately received.

IDENTIFICATION OF THE TRANSACTION 13

13 The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

SALE OF GOODS 14–19

14 Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:

a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;

b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

c) the amount of revenue can be measured reliably;

d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

The contractual acceptance by the customer is the key issue.

DISCLOSURE

35 An entity shall disclose:

a) the accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services;

Many businesses still have poorly defined accounting policies with respect to revenue.

F Significant differences in GAAP

US GAAP

Classes of revenue and acting as agent

US GAAP is more detailed and for revenue there is extensive guidance on revenue recognition specific to the industry and type of contract. There are also specific indicators to assist in evaluating whether an entity is acting as a principal or agent. When a transaction comprises multiple elements there is detailed guidance that must be followed.

Construction contracts

Construction contracts (including fixed price contracts) are accounted for using the percentage-of-completion method only if certain criteria are met otherwise the completed contract method is used.

Note. *IAS 18 on Revenue is being revised (with much more specific detail) as a converged standard focusing on an asset and liability model. This will link with revenue recognition in IAS 11 Construction contracts. Possible date 2011.*

10
The effects of changes in foreign exchange rates – IAS 21

A Key Points

- Exchange rates fluctuate.
- What rates should be used for translating accounts from one currency to another?
- The standard sets out what rates should be used and where gains and losses arising from currency translation should be disclosed.
- Discrete transactions should be translated into an entities functional currency (often, but not always its home country currency).
- Where there is a net investment in foreign operations – e.g. subsidiaries of a group – different rules apply.

B What does the IAS contain?

C Why needed

Trade and financial transactions are carried on between countries that have different currencies that continually fluctuate in relative value. There are many possible ways of translating financial statements in one currency into those of another. The issue is how to report a period's results and balance sheet position when business is carried on in different currencies and exchange rates fluctuate.

D Ideas – concepts

The underlying principal should be that results and assets and liabilities should not be distorted in amount simply through using an inappropriate

translation method or exchange rate. The aim must be to present the figures in the accounts of the reporting entity's currency as fairly as possible. Thus transactions should be translated at the rate ruling at the date of the transaction. Balance sheet figures should be translated at the rate ruling at the balance sheet date. For non-monetary (fixed) assets and liabilities the historical rate should be used.

Foreign entities – net investment approach

A common way to mitigate the effect of changes in exchange rates is to purchase the foreign assets (investment in an entity) with finance denominated in the same or linked foreign currency. Thus any change in the asset value on translation should be more or less off-set by a compensating change in liability amount – this is an example of hedging.

E Key Content of the Standard

Objective

1 An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In addition, an entity may present its financial statements in a foreign currency.

The objective of this standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

2 The principal issues are: which exchange rate(s) to use; and how to report the effects of changes in exchange rates in the financial statements.

Definitions

Closing rate is the spot exchange rate at the end of the reporting period.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

A group is a parent and all its subsidiaries.

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.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

Presentation currency is the currency in which the financial statements are presented.

Spot exchange rate is the exchange rate for immediate delivery.

Required Practice

Functional currency

9 The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

a) the currency:

i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Although often obvious the clear identification of the functional currency is vital. Paragraph 10 to 13 set out further factors that may provide evidence of an entity's functional currency.

Initial recognition

21 A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

Reporting at the ends of subsequent reporting periods

23 At the end of each reporting period:

a) foreign currency monetary items shall be translated using the closing rate;

b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and (for a tangible fixed asset the historic rate at time of purchase)

c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined.

If the fair values are year end fair values (as may often be the case) then the rate used will be the closing rate.

Recognition of exchange differences

28 Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32.

30 When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange component of that gain or loss shall be recognised in other comprehensive income. Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss.

32 Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation (see paragraph 15) shall be recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate. In the financial statements that include the foreign operation and the reporting entity (e.g. consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment in accordance with paragraph 48.

USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

39 The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

a) assets and liabilities for each statement of financial position presented (i.e. including comparatives) shall be translated at the closing rate at the date of that statement of financial position;

b) income and expenses for each statement of comprehensive income or separate income statement presented (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions; and

c) all resulting exchange differences shall be recognised in other comprehensive income.

DISCLOSURE

52 An entity shall disclose:

a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with IAS 39; and

b) net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

53 When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency.

F Significant differences in GAAP

US GAAP

The approach of US GAAP is basically similar and at present there are no moves to further convergence. There are some, normally not significant, differences.

Reporting currency

Entities can only have one reporting currency.

Subsidiaries where high inflation prevails

For financial statements of a foreign operation in a highly inflationary economy measurement should be as if the parent's reporting currency were its functional currency.

UK GAAP

FRS 23 is identical to IAS 21.

But note SSAP 20 – Foreign Currency Translation may still apply to companies not adopting IFRS.

11
Employee benefits – IAS 19

A Key points

- If employees are promised pensions – defined retirement benefits – then a business has a liability.
- The assets (investments) held directly or in trust to meet the commitments may or may not cover the expected liabilities.
- An actuarial estimate of the present value of liabilities should be compared with the worth of the investments and any deficit (or surplus) calculated and accounted for.
- Defined benefit pension liabilities are REAL!

B What does the IAS contain?

One of the longest lists of contents of any IFRS!

C Why needed

The cost of providing pensions is often very significant, especially where the pension is a guaranteed amount linked to the final salary level of the employee. To provide for these future liabilities amounts are set aside in a separate managed fund, sufficient to cover the likely cost of all pension commitments. When a company is growing and successful, with an expanding workforce in a generally growing economy, then presumably the funds put aside will grow (the investments will give returns that are reinvested) sufficiently to cover all future pension liabilities. BUT what happens in a stagnant business, in a stagnant economy where investment returns are poor? The answer: inadequate funds to meet future pension liabilities.

There are also other types of employee benefit (including salaries, redundancy or termination benefits etc.) for which the accounting may need to be clearly defined. But it is the funding of pensions that is the most controversial – causing the biggest cost to companies, possibly there will be huge liabilities. This is real concern to businesses, governments, employees and pensioners.

D Ideas – concepts

Defined benefit pension schemes potentially offer employees financial security in retirement, but at a present cost to the company. The payment of the liability may be deferred, but the cost of settling the liability should be charged to the income statement now. It is the present liability of the company that needs to be known and revealed. This liability manifests itself year by year in the amounts needed to be charged to the income statement to build up a sufficient fund to meet the future pension liabilities.

Liabilities, particularly future liabilities, should be fully accounted for and disclosed. Promises to provide pensions are very real commitments and the liability attaching should be calculated and accounted for.

IF the following were know with certainty:

- the life expectancy of retirees;
- the amounts payable each year (possibly adjusted for inflation); and
- the returns on funds invested;

then actuaries could with confidence say how much should be invested each year to provide the funds necessary to meet the calculated future liabilities.

All of the above data are to a degree subjective, but it is the returns on funds invested, that in the last few years have not just been uncertain, but sharply declining from that which had been confidently anticipated.

E Key Content of the Standard

Objective

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an entity to recognise:

a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Definitions

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Current service cost is the increase in the present value of a defined benefit obligation resulting from employee service in the current period.

Interest cost is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

Plan assets comprise:

a) assets held by a long-term employee benefit fund; and

b) qualifying insurance policies.

A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in IAS 24 Related Party Disclosures) of the reporting entity, if the proceeds of the policy:

a) can be used only to pay or fund employee benefits under a defined benefit plan; and

b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

   i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

   ii) the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

The return on plan assets is interest, dividends and other revenue derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less any costs of administering the plan (other than those included in the actuarial assumptions used to measure the defined benefit obligation) and less any tax payable by the plan itself.

Actuarial gains and losses comprise:

a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and

b) the effects of changes in actuarial assumptions.

Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when existing benefits are changed so that the present value of the defined benefit obligation decreases).

Required Practice

IAS 19 is 'specialist' in that you either have to deal with defined benefit pension schemes or not. It is often 'political' and causes real problems, particularly for long established and declining industry sectors. Rather than select the required practice, which swings between the obvious and complex, an understanding of the key requirements can be found in the Standard's introductory notes:

IN2 The Standard identifies four categories of employee benefits:

a) short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;

c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are payable twelve months or more after the end of the period, profit-sharing, bonuses and deferred compensation; and

d) termination benefits.

IN4 Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans. The Standard gives specific guidance on the classification of multi-employer plans, state plans and plans with insured benefits.

IN5 Under defined contribution plans, an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. The standard requires an entity to recognise contributions to a

defined contribution plan when an employee has rendered service in exchange for those contributions.

IN6 All other post-employment benefit plans are defined benefit plans. Defined benefit plans may be unfunded, or they may be wholly or partly funded. The Standard requires an entity to:

a) account not only for its legal obligation, but also for any constructive obligation that arises from the entity's practices;

b) determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period;

F Significant differences in GAAP

US GAAP

The general principles are similar.

Classes of post-employment benefit

Under US GAAP post-employment benefits are divided into post retirement benefits (provided during retirement) and other post-employment benefits (provided after the cessation of employment but before retirement). The accounting for post employment benefits depends on the type of benefit provided.

Measuring liabilities

The liability and expense are measured actuarially using the projected unit credit method. The defined benefit obligation must be discounted using a high quality corporate bond rate.

There are many other detailed differences – it is a specialist and complex area.

UK GAAP

The requirements of FRS 17 Retirement Benefits are consistent with IAS 19 (revised) in most respects. The only major difference is the recognition of actuarial gains and losses. The FRS requires actuarial gains and losses to be recognised, immediately they occur, in the statement of total recognised gains and losses.

12
Share based payment – IFRS 2

A Key Points

- For new businesses (for example in the e-business sector) cash flow may be tight but there will be great expectations for the future.
- Many suppliers and more so employees have to (and will) happily accept payment in the form of shares of the venture.
- Shares granted are not 'free'.
- What is the cost of these payments? That is the issue.

B What does the IAS contain?

C Why needed

Entities often grant shares or share options to employees or other parties. Share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services. Shareholders normally will have voted approval of such payment schemes, but without calculation of the cost of the payment and full disclosure of long term effects such payments may

appear 'free'. Awarding shares or share options means that a portion of the value of the company is being given away.

A stark example of the long term effect could be found in some US high-tech companies who awarded staff with generous share options, the attraction to staff being the apparently limitless rise in the share price. The earnings per share (eps), being profit available for shareholders divided by the eligible number of shares could for example be 14 cents per share in respect of shares currently issued, but if all share options were exercised then the (diluted) eps figures could be as little as 6 cents per share. In effect the present owners could end up owning less than half of the company.

D Ideas – concepts

The basic idea is to put a value on the cost of awarding share based payments and to recognise that cost immediately in profit and loss – there is no such thing as a free lunch!

E Key Content of the Standard

Objective

1 The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.

Share-based payment transaction. A transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options), or acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of the entity's shares or other equity instruments of the entity.

Share option. A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

Vest. To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.

Required Practice

IFRS 2 is 'specialist' in that you either have to deal with share based payments or not. It is only applicable where the fashion or practice of paying or rewarding with shares occurs. An understanding of the key requirements can be found in the introductory notes – rather than overwhelm with the key required practice of this very detailed standard:

IN1 Entities often grant shares or share options to employees or other parties. Share plans and share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.

Main features of the IFRS

IN3 The IFRS requires an entity to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity. There are no exceptions to the IFRS, other than for transactions to which other Standards apply.

IN4 The IFRS sets out measurement principles and specific requirements for three types of share-based payment transactions:

a) equity-settled share-based payment transactions

b) cash-settled share-based payment transactions; and

c) transactions in which the entity receives or acquires goods or services

IN8 The IFRS prescribes various disclosure requirements to enable users of financial statements to understand:

a) the nature and extent of share-based payment arrangements that existed during the period;

b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined; and

c) the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

F Significant differences in GAAP

US GAAP

FAS 123 Share based payment is generally similar to IFRS 2. They both require a fair value based approach when accounting for arrangements where suppliers of goods or services or employees are paid in shares.

UK GAAP

FRS 20 is identical to IFRS 2.

13
Borrowing costs – IAS 23

A Key points

- Large capital (construction) projects often have linked borrowings and related (interest) costs.
- There will be no revenues from projects during the construction period against which to match the borrowing costs.
- The borrowing costs are as much a cost of construction as say the civil work or equipment and should be capitalised.
- Conversely borrowing costs related to ongoing and general funding should be charged against income as incurred.

B What does the IAS contain?

C Why needed

Borrowing costs related to the funding of revenue earning fixed assets are a recurring cost of operation and should be charged against the revenue earned. But what about funding the construction of future revenue earning fixed assets? A legitimate argument is that borrowing costs should be capitalised during a fixed asset's construction phase.

However unless clear rules exist, borrowing costs could disappear from the P&L account, instead appearing as a constituent of a fixed assets 'worth'! Capitalising revenue related costs was one of the techniques used by Worldcom to lower costs, and thus enhance earnings.

D Ideas – concepts

Borrowing costs are an inevitable cost of funding business activities. They should most prudently be considered a cost to be charged as incurred against revenue.

However, fixed assets often require considerable funds to finance their construction or purchase. Borrowing costs incurred during the construction phase are rightly considered a necessary cost to bring the asset into a revenue earning condition, that is, they are a cost of the fixed asset as much as materials or labour are. A good way of justifying this view is to consider that if a business purchased a completed property say, the construction company that built the property would have factored into its selling price the borrowing costs of funding their work in progress during the property's construction.

E Key Content of the Standard

Objective

See the Core Principle below (a new idea from the standard setters!)

Definitions

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Required Practice

CORE PRINCIPLE 1

1 Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.

RECOGNITION 8–25

8 An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

Commencement of capitalisation

17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

a) it incurs expenditures for the asset;

b) it incurs borrowing costs; and

c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

Suspension of capitalisation

20 An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

Cessation of capitalisation

22 An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

24 When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

DISCLOSURE

26 An entity shall disclose:

a) the amount of borrowing costs capitalised during the period; and

b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

F Significant differences in GAAP

US GAAP

Interest earned

Any interest earned on unused borrowings generally cannot be offset against interest costs.

Calculation of borrowing costs

The borrowing costs related to specific qualifying assets are calculated as the weighted average accumulated expenditure times the borrowing rate. (IAS 23 capitalises the borrowing costs actually incurred).

UK GAAP

FRS 15 Tangible Fixed Assets permits but does not demand capitalisation of finance (borrowing) costs.

14
Accounting for government grants – IAS 20

A Key points

- Are grants related to capital (asset) expenditure or revenue?
- Revenue grants should be accounted for and reported in the income statement.
- How should capital (related to tangible fixed assets) be accounted for?

B What does the IAS contain?

C Why needed

There are different types of grant. Different names can also be used, e.g. subventions, subsidies etc. Grants may be given in support of either revenue or capital expenditure. Grants may also be unconditional or conditional upon achieving some target, e.g. numbers of people employed.

Without clear accounting rules the benefit of grants to businesses could be seriously miss-represented. For example, conditional grants given to support capital expenditure where the benefits accrue over the years of proper usage of the asset, could be credited directly to earnings in one year, without restriction.

Grants are given either as a contribution to revenue costs – e.g. 50% of the cost of wages reimbursed for a six month period to encourage employment, OR to encourage the investment in and use of assets – e.g. 40% of the cost of electronic equipment reimbursed.

It should be obvious that revenue grants are credited to the income statement as a reduction in the relevant cost, and capital grants are either credited as a reduction in the cost of the asset in the balance sheet, or held as a reserve to be released to the income statement as the relevant asset is consumed or depreciated. However, without this Standard some might argue that capital grants are in effect income and thus credit the whole amount to the P&L account.

D Ideas – concepts

The accruals concept requires that revenue and costs are accrued, that is, matched with one another so far as their relationship can be established or justifiably assumed. They are dealt with in the income statement of the period to which they relate.

Prudence means being cautious. Prudence is the inclusion of a degree of caution in the exercise of judgment needed in making the estimates required under conditions of uncertainty, such that assets or expenses are not overstated, and liabilities or expenses are not understated.

Accordingly government grants should not be recognised in the income statement until the conditions for their receipt have been complied with and there is reasonable assurance that the grant will be received (and not be repayable to the provider).

Revenue grants that support a business by reducing running costs should be credited to earnings and the benefit in the accounting period affected should be disclosed.

Capital grants given to support purchase of fixed assets (infrastructure) that will benefit the business over the life of the assets, through a reduced charge for depreciation, should be shown as a liability and credited to the income statement as the asset is consumed – depreciated. Thus the benefit of the grant will be correctly matched with the use of the asset. Any conditions attaching to grants, e.g. reaching certain production or employment targets, should be disclosed.

E Key Content of the Standard

Objective

This 'old' IAS did not have an objective.

Definitions

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets. Forgivable loans are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

Required Practice

GOVERNMENT GRANTS

7 Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

a) the entity will comply with the conditions attaching to them; and

b) the grants will be received.

12 Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

20 A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognised in profit or loss of the period in which it becomes receivable.

24 Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

39 The following matters shall be disclosed:

a) the accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements;

b) the nature and extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited; and

c) unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.

IAS 20 is under review – comments from the IASB

The Board's objectives in this project are to update IAS 20 for the following reasons:

a) The recognition requirements of IAS 20 often result in accounting that is inconsistent with the Framework, in particular the recognition of a deferred credit when the entity has no liability.

b) As well as being inconsistent with the Framework, the recognition requirements of IAS 20 are also inconsistent with more recent pronouncements of standard-setting bodies relating to either non-reciprocal transfers in general or, more specifically, government grants.

c) IAS 20 contains numerous options. Apart from reducing the comparability of financial statements, the options in IAS 20 can result in understatement of the assets controlled by the entity and do not provide the most relevant information to users of financial statements.

It is amusing to some of us, that this project is held up due to the fact that the 'clever' economist style definition of a liability does not fit with the concept of deferred income!

F Significant differences in GAAP

US GAAP

No specific guidance

There is no specific guidance on the accounting for grants from government.

Contributed assets

Unlike IFRSs a contributed non-monetary asset must be recognised at fair value when fair value can be measured reliably.

UK GAAP

SSAP 4 – Accounting for Government Grants is a very old standard (although it has been updated over the years). The standard accords very closely with IAS 20.

Non-monetary (tangible fixed) assets contributed to a charity should be measured at fair value.

15
Income taxes/current tax/deferred tax – IAS 12

A Key points

- Tax charges (or credits) are often material and 'political' – full disclosure is needed.
- The allocation of tax allowances often differs from accruals accounting – tax charges may be deferred.
- How and where should deferred tax be accounted for?

B What does the IAS contain?

C Why needed

Where tax is levied it obviously has to be charged as a cost matched with the profits or gains to which it relates. However, tax laws do not always result in tax being charged on the accounting profit shown, or at rates and times that match the accounting profit. Thus to understand the tax

charge in financial statements there is inevitably need for disclosures of the basis of the charge.

A particular timing issue may arise in many countries due to favourable tax depreciation charges – 'writing down allowances' for fixed assets. These generous allowances are given against profits, the aim being to encourage investment in fixed assets and infrastructure. When a company purchases new assets and benefits from the generous writing down allowances, the tax that has to be paid may be much lower than that indicated by the prevailing rate for taxes on profits. This is because the tax authorities ignore, that is, add back the accounting depreciation charges and substitute their own, more generous allowance. Over the period of asset ownership the full amount of tax has to be paid – less in earlier years as the actual tax is deferred, but more in later years – this is deferred tax.

There may be other distortions and anomalies arising out of a particular tax regime – these should be disclosed.

D Ideas – concepts

Taxable profits

The accounting profit or loss disclosed in a set of financial statements is rarely the profit or loss on which tax is charged. Whether an expense is allowable or income is taxable and when any tax is payable, often differs from the basis used in accounts preparation. Examples:

- interest earned or paid is often taxed on a cash rather than accruals basis;
- expenses for entertainment or parking fines, whilst costs of business are considered disallowable expenses by tax authorities.

Deferred tax

Over the full life of an asset purchased and then fully depreciated, the total tax charge should be the same. With generous tax writing down allowances the tax to be paid is lower in the earlier years, but this is

balanced by increasing charges at the end of the assets life. The payment of the tax is deferred but the total tax liability over the asset's life is the same. A good way of describing this is to call the deferred tax provision account a 'tax equalisation' exercise.

E Key Content of the Standard

Objective

The objective of this Standard is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

a) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position; and

b) transactions and other events of the current period that are recognised in an entity's financial statements.

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions.

This Standard requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognised in profit or loss, any related tax effects are also recognised in profit or loss. For transactions and other events recognised outside profit or loss (either in other comprehensive income or directly in equity), any related tax effects are also recognised outside profit or loss (either in other comprehensive income or directly in equity, respectively). Similarly, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill arising in that business combination or the amount of the bargain purchase gain recognised.

This Standard also deals with the recognition of deferred tax assets arising from unused tax losses or unused tax credits, the presentation of income taxes in the financial statements and the disclosure of information relating to income taxes.

Definitions

Accounting profit is profit or loss for a period before deducting tax expense.

Taxable profit (tax loss) is 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) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

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:

a) deductible temporary differences;

b) the carryforward of unused tax losses; and

c) the carryforward 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.

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Required Practice

RECOGNITION OF CURRENT TAX LIABILITIES AND CURRENT TAX ASSETS

12 Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.

13 The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an asset.

RECOGNITION OF DEFERRED TAX LIABILITIES AND DEFERRED TAX ASSETS

15 A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

a) the initial recognition of goodwill; or

b) the initial recognition of an asset or liability in a transaction which:

i) is not a business combination; and

ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised in accordance with paragraph 39.

If would be difficult to set out clear conditions and rules for partial provision. The Standard setters have taken the simplistic approach of requiring full liability for deferred tax. However this approach does mean that companies will show liabilities that may never be paid. The arithmetic or mathematical progressions suggests that if a company grows (as most hope to), continually invests greater amounts in eligible assets and the tax regime does not change dramatically

then the deferred tax amount will just grow and grow. The point is when reviewing balance sheets – just how much of a real, soon to be settled in cash, liability is the deferred tax?

MEASUREMENT

46 Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

47 Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

51 The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

53 Deferred tax assets and liabilities shall not be discounted.

56 The carrying amount of a deferred tax asset shall be reviewed at the end of each reporting period.

Offset

71 An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:

a) has a legally enforceable right to set off the recognised amounts; and

b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Tax expense

77 The tax expense (income) related to profit or loss from ordinary activities shall be presented in the statement of comprehensive income.

DISCLOSURE

79 The major components of tax expense (income) shall be disclosed separately.

This is followed by nearly two pages in Paragraphs 80, 81, 82 and 82a of, where applicable, further disclosure.

F Significant differences in GAAP

US GAAP

US GAPP is generally similar.

At their joint meeting in October 2009 the IASB and the FASB considered a summary of the comments received by the IASB in response to the proposals for a revised income taxes standard exposed by the IASB in early 2009. The Boards indicated that they would consider undertaking a fundamental review of accounting for income taxes at some time in the future. In the meantime, the IASB staff plans to present options on how the IASB should proceed with the proposals in the exposure draft at the November IASB meeting. It is unlikely that the project will proceed in its current form

UK GAAP

There are considerable differences:

Current tax

IAS 12 has similar requirements as FRS 16. However the IAS requires current tax liability (or asset) to be shown on the face of the balance sheet – this would normally be in a balance sheet note under UK GAAP.

IAS 12 requires current tax that relates to items charged or credited to equity to be charged/credited in equity. FRS 19 requires all current tax to be included in the statement of performance – the P&L account or STRGL.

Deferred tax

Firstly there is a **conceptual difference**.

FRS 19 requires deferred tax to be recognised on the basis of timing differences.

IAS 12 requires recognition of deferred tax on the basis of taxable temporary differences. Temporary differences include all timing differences and many permanent differences.

Revaluation gains – under FRS 19 deferred tax is only recognised on revaluation gains if:

a) there is a binding agreement to sell the revalued asset and the expected gain has been recognised; or

b) where an asset is subject to continual revaluation to fair value with changes in fair value being taken to P&L.

Discounting future deferred tax liabilities is allowed by UK GAAP but prohibited by IAS 19.

Disclosure – reconciliations. IAS 12 requires a reconciliation of the total (current and deferred) tax charge to the standard tax charge. FRS 19 requires the reconciliation to be carried out for the current tax charge.

16
Non-current Assets Held for Sale and Discontinued Operations – IFRS 5

The income and profit or loss from operations that are discontinued may be material and should be disclosed in the income statement. This IFRS is reviewed in its entirety in the section dealing with balance sheet items – 'assets held for sale'.

A Key points

- Business sectors or specific activities cease and may be sold.
- Users of accounts need to know what has ceased and what will continue.
- The income and results of the ceasing activities should be disclosed.
- The value of assets related to the discontinued activities will inevitably change – these assets and their expected values should be disclosed separately on the balance sheet.

B What does the IAS contain?

C Why needed

The idea of disclosing discontinued operations (sales, costs, profits or losses) separately from continuing operations has been around for some time (this standard replaces IAS 35 discontinued operations) and makes obvious sense. Such disclosure allows users of accounts to understand the effect of disposal of operations and the sales etc of those parts of the business that will continue.

Without definition of assets held for sale (as a result of disposals) a range of values could be placed on such assets. The standard defines non-current (fixed) assets held for sale.

The drive to have a separate standard, rather than include definitions and accounting in other standards comes from the drive to converge standards. The introduction of the standard specifically mentions this point.

D Ideas – concepts

As is established practice, the components of a businesses total profit or loss should be disclosed. That is continuing profits or losses should be distinguished from profits or losses from discontinued transactions (also from one off profits or losses – IAS 8).

E Key Content of the Standard

Objective

1 The objective of this IFRS is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations.

Definitions

Discontinued operation. A component of an entity that either has been disposed of or is classified as held for sale and:

a) represents a separate major line of business or geographical area of operations,

b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

c) is a subsidiary acquired exclusively with a view to resale life.

Required Practice

PRESENTATION AND DISCLOSURE 30–42

30 An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

Presenting discontinued operations

33 An entity shall disclose:

a) a single amount in the statement of comprehensive income comprising the total of:

i) the post-tax profit or loss of discontinued operations and

ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

b) an analysis of the single amount in (a) into:

i) the revenue, expenses and pre-tax profit or loss of discontinued operations;

ii) the related income tax expense as required by paragraph 81(h) of IAS 12;

iii) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and

iv) the related income tax expense as required by paragraph 81(h) of IAS 12.

The analysis may be presented in the notes or in the statement of comprehensive income.

Gains or losses relating to continuing operations

37 Any gain or loss on the re-measurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation shall be included in profit or loss from continuing operations.

F Significant differences in GAAP

US GAAP

A disposal transaction may be only a portion of a separate line of business. Additionally, unlike IFRSs, the entity cannot have significant continuing involvement in the operation after disposal.

Cash flows

Cash flow information for discontinued operations is not required to be disclosed. Cash flow information is re-presented only if cash flow information of discontinued operations is presented separately for the current reporting period.

UK GAAP

Discontinued operations are dealt with in FRS 3 Reporting Financial Performance.

Definition of discontinued operations

The FRS definition of discontinued operations: it is an operation, the discontinuance of which, will have a material effect on the nature and focus of the reporting entity's operations. This might lead to a different classification than under IFRS.

Depreciation of assets held for sale

Under FRS assets held for sale may continue to be depreciated this is not allowed under IFRS 5.

17
Earnings per share – IAS 33

A Key points

- Earnings per share are considered an important performance measure.
- The arithmetic is simple – earnings for the period/number of shares.
- BUT what earnings figures is to be used? e.g. before one off items?
- AND what number of shares – is it those in issue or those including share options?

B What does the IAS contain?

C Why needed

Many businesses, investors and analysts consider earnings per ordinary share (eps) as a prime measure of success (as long as they increase!). If there were no clear definition of what comprised 'earnings' the amount of earnings (profit) would be open to varying interpretations. Also it is possible to take differing views on the number of shares to be used in the denominator, e.g. should it be the number of shares in issue at the balance sheet date or the average number of shares in circulation during the year.

A further issue is that many companies have financial instruments, e.g. convertible loans, that if converted to ordinary shares would 'dilute' the eps figure.

Yet a more significant issue for some companies (e-businesses and high-tech businesses) is that share options have been granted to directors and managers. If all these options were to be exercised then the eps figures would be significantly lower or 'diluted'.

D Ideas – concepts

Earnings per share is a measure of profitability. It is how much available profit, normally expressed in pence or cents, is generated per ordinary share issued.

The idea is to show consistently among years and companies the profit attributable to each ordinary share owned. In a well managed company it would be expected that eps would increase year on year. Higher eps would allow higher dividends per share to be distributed. The projected growth of divided yield (per share) is an important figure when valuing shares.

E Key Content of the Standard

Objective

1 The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity. Even though earnings per share data have limitations because of the different accounting policies that may be used for determining 'earnings', a consistently determined denominator enhances financial reporting. The focus of this Standard is on the denominator of the earnings per share calculation.

Definitions

Antidilution is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

A contingent share agreement is an agreement to issue shares that is dependent on the satisfaction of specified conditions.

Contingently issuable ordinary shares are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

Options, warrants and their equivalents are financial instruments that give the holder the right to purchase ordinary shares.

An ordinary share is an equity instrument that is subordinate to all other classes of equity instruments.

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares.

Put options on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.

Required Practice

MEASUREMENT

Basic earnings per share

9 An entity shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

10 Basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.

Earnings

12 For the purpose of calculating basic earnings per share, the amounts attributable to ordinary equity holders of the parent entity in respect of:

a) profit or loss from continuing operations attributable to the parent entity; and

b) profit or loss attributable to the parent entity shall be the amounts in (a) and (b) adjusted for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

Shares

19 For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period.

Diluted earnings per share

30 An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

PRESENTATION

66 An entity shall present in the statement of comprehensive income basic and diluted earnings per share for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period. An entity shall present basic and diluted earnings per share with equal prominence for all periods presented.

DISCLOSURE

70 An entity shall disclose the following:

a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

b) the weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

c) instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future, but were not included in the calculation of diluted earnings per share because they are antidilutive for the period(s) presented.

d) a description of ordinary share transactions or potential ordinary share transactions, other than those accounted for in accordance with paragraph 64, that occur after the reporting period and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

F Significant differences in GAAP

US GAAP

FAS 128 Earnings per share is substantially the same as IAS 33.

Extraordinary items

Entities with an extraordinary item must present EPS data for those line items either on the income statement or in the notes to the financial statements.

Alternative bases

Adjusted basic and diluted EPS based on alternative earnings measures are not allowed.

UK GAAP

FRS 22 – Earnings per share has the effect of implementing IAS 33 (revised 2003) for such entities not preparing their financial statements in accordance with IFRS.

18
Property plant and equipment – IAS16

A Key points

- Tangible fixed assets such as property, plant and equipment should be shown on the balance sheet, however:
  - At what values should (tangible fixed) assets be measured?
  - What happens as assets wear out or are consumed?
  - What happens if assets become outmoded or redundant?
- This standard aims to answer these and related questions.

B What does the IAS contain?

C Why needed

Property, plant and equipment or tangible fixed assets are frequently major assets and thus components of capital employed in businesses. Stating how they are valued is essential to an understanding of balance sheet worth. A related issue is whether tangible fixed assets hold real value. Worldcom was a good example of a business capitalising costs – treating operating costs as fixed assets, thus reducing costs, increasing profits and increasing balance sheet 'worth'!

D Ideas – concepts

The principal issue with tangible fixed assets is – at what value are they stated in the balance sheet? Also is the cost of use or loss in value, of the asset fairly reported in the profit and loss account? The following are specific value related issues.

Tangible fixed assets have to be shown in a balance sheet, but at what value? 'Value' could mean cost, a written down value or a revalued amount.

The simplest approach is to record them at what they originally cost, thereafter reducing the cost by charging a deduction for consumption as they are consumed in generating profits – as they depreciate with use.

Tangible fixed assets such as property frequently appreciate in value. They should best be shown at revalued amount.

Assets can cease to hold value. For example, specialised equipment in a business making products for which there is a sudden, permanent lack of demand. The value of this plant and equipment has been impaired and thus the asset value should be written down to a recoverable amount, if any.

Profits or losses on disposal or impairment of fixed assets occur in the normal course of business, but are often large in amount and should be reported separately.

E Key Content of the Standard

Objective

1 The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

Definitions

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 Share-based Payment.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value. Depreciation is the systematic allocation of the depreciable count of an asset over its useful life.

Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Property, plant and equipment are tangible items that:

a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

b) are expected to be used during more than one period.

Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.

The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

a) the period over which an asset is expected to be available for use by an entity; or

b) the number of production or similar units expected to be obtained from the asset by an entity.

Required Practice

RECOGNITION

7 The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

a) it is probable that future economic benefits associated with the item will flow to the entity; and

b) the cost of the item can be measured reliably

This should rule out capitalising costs (out of income statement expenses) into assets that have no value – the inability to generate costs in the future.

Subsequent costs

12 Under the recognition principle in paragraph 7, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

MEASUREMENT AT RECOGNITION

15 An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

MEASUREMENT AFTER RECOGNITION

29 An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

Cost model

30 After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation model

31 After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

39 If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

40 If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

Depreciation

43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

This leads to so called 'component' accounting. For example a steel mill may have an expected life of at least 50 years but

drive motors (significant components) lives of only 20 years. The different parts or components should be depreciated over appropriate numbers of years.

48 The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset.

Depreciable amount and depreciation period

50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Paragraphs 50 and 51 dictate that simply writing an asset off over a reasonable period to zero value will not be appropriate where life may be extended or shortened and there is a material residual value.

52 Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

53 The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

Depreciation method

60 The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

61 The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

Paragraphs 60 and 61 reinforce (50 and 51) that simple straight line depreciation may not be sophisticated enough.

DERECOGNITION

67 The carrying amount of an item of property, plant and equipment shall be derecognised:

a) on disposal; or

b) when no future economic benefits are expected from its use or disposal.

68 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless IAS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

71 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

DISCLOSURE

73 The financial statements shall disclose, for each class of property, plant and equipment:

a) the measurement bases used for determining the gross carrying amount;

b) the depreciation methods used;

c) the useful lives or the depreciation rates used;

d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

e) a reconciliation of the carrying amount at the beginning and end of the period.

There is potentially a LOT of disclosure.

F Significant differences in GAAP

US GAAP

The general concepts of incorporating assets in the balance sheet, depreciation and capitalisation are similar.

A potentially significant difference is that the revaluation of property, plant and equipment is not permitted under US GAAP.

Component depreciation is allowed but not commonly done in practice.

UK GAAP

As for US GAPP the principles are similar. Revaluation is allowed but there are differences in definitions and detailed application.

19
Investment property – IAS 40

A Key points

- This class of property is held for its investment potential.
- Investment property is an asset not utilised by a business.
- Investment properties are measured either at cost or, more likely revalued amount.

B What does the IAS contain?

C Why needed

Tangible fixed assets are generally subject to depreciation charges to reflect on a systematic basis the wearing out, consumption or other loss of value. A different treatment is required where property fixed assets are held not for consumption but as investments. The current value and changes in that value are of prime importance.

D Ideas – concepts

Investment properties are held for gain in value – they are not 'consumable' assets and therefore should not be depreciated.

E Key Content of the Standard

Objective

1 The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

Definitions

Carrying amount is the amount at which an asset is recognised in the statement of financial position.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 Share-based Payment.

Required Practice

6 A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model set out in paragraphs 33–55 for the asset recognised.

This paragraph has to be read in conjunction with paragraph 25. Paragraphs 6 and 25 anticipate that in future leased properties may have to be shown as an asset with a corresponding contra liability (being the present value of future lease payments).

RECOGNITION

16 Investment property shall be recognised as an asset when, and only when:

a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

b) the cost of the investment property can be measured reliably.

MEASUREMENT AT RECOGNITION 20–29

20 An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

25 The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease by paragraph 20 of IAS 17.

MEASUREMENT AFTER RECOGNITION

Accounting policy

30 With the exceptions noted in paragraphs 32A and 34, an entity shall choose as its accounting policy either the fair value model in paragraphs 33–55 or the cost model in paragraph 56 and shall apply that policy to all of its investment property.

Fair value model

33 After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value, except in the cases described in paragraph 53.

34 When a property interest held by a lessee under an operating lease is classified as an investment property under paragraph 6, paragraph 30 is not elective; the fair value model shall be applied.

35 A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises.

38 The fair value of investment property shall reflect market conditions at the end of the reporting period.

Cost model 56

56 After initial recognition, an entity that chooses the cost model shall measure all of its investment properties in accordance with IAS 16's requirements for that model, other than those that meet the criteria to be classified as held for sale.

DISCLOSURE

Fair value model and cost model

As in IAS 16 Property, plant and equipment there is potentially a LOT of disclosure required.

F Significant differences in GAAP

US GAAP

US GAAP does not recognise investment property as a separate class of asset. Investment properties are thus included with other tangible assets in use or as assets held for sale as appropriate.

As under IAS 40 investment property is recognised initially at cost but subsequent revaluation is not permitted.

Property held by a lessee under an operating lease cannot be recognised in the balance sheet.

There is no requirement to disclose the fair value of investment property.

UK GAAP

SSAP 19 has different measurement bases from IAS 40 and recognition of gains and losses on revaluation can be different.

Measurement

SSAP 19 requires an investment property to be carried at open market value. IAS 40 allows an investment property to be carried at fair value or depreciated historical cost.

Recognition of gains and losses

Under SSAP 19 any gain or loss on revaluation is recognised in the STRGL (statement of total recognised gains and losses), unless a loss is a permanent write down. Under IAS 40 gains or losses due to changes in fair value are recognised in the income statement.

20
Intangible Assets – IAS 38

A Key points

- What is an intangible asset?
- How can one be recognised and measured if it cannot be touched?
- How should goodwill be accounted for?
- Should research and development be recognised?
- The standard aims to answer these questions.

B What does the IAS contain?

C Why needed

For many businesses the principal assets they own and employ in business are 'intangible' fixed assets, that is, they are long-term assets with lives of more than 12 months. They are the 'infrastructure' on which, and by which, the business earns its future cash flows and profits. One meaning of intangible is 'not recognisable by the sense of touch' this implies that assets cannot be touched but the meaning implied by accountants is more realistically interpreted as 'difficult to value'. Intangibles such as patents, brands, know-how and, in general terms, goodwill are difficult to value. A prudent treatment would be to write off the intangible as soon as it was purchased. This write-off would be done across the balance sheet, against retained profits or reserves. Whilst prudent, this has the effect of understating the capital employed in the business.

Unless the premium paid for goodwill really was for a worthless asset then there would be some future enhanced earnings arising out of the goodwill – these would show up in subsequent earnings figures.

A fairer presentation is considered to be to show the goodwill as an asset (thus part of capital employed and the corresponding funding). This intangible fixed asset should then be charged (amortised) to the profit and loss account over the period for which enhanced earnings arise – the matching concept.

D Ideas – concepts

Intangible things are difficult to comprehend – the second meaning in the Oxford English Dictionary is 'That cannot be grasped mentally'! Thus premia paid for goodwill and its constituents, a name, brands, patents, know-how etc., may be difficult to value. However, money has been paid and the value at date of acquisition is presumably a fair value. But what is fair? If several companies are chasing a 'must have' business then rational fairness goes out the window!

Purchased intangibles are part of the capital employed of a business and should be shown at cost in the balance sheet. The view is that intangibles

should not be written off, but rather retained on the balance sheet at cost unless the intangible has a shorter life. For example, a license that expires after 7 years would be written off over 7 years.

If it can be demonstrated that the intangible's value, e.g. a brand name, is supported by expense on promotion etc., then the intangible can remain in the balance sheet at cost.

The exercise of checking whether the intangible holds value is carried out as an 'impairment' review (see IAS 36 -Impairment of Assets). The argument is that the promotion costs etc., are the matched costs to be deducted from income – the intangible retains its value.

E Key Content of the Standard

Objective

1 The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

Definitions

An active market is a market in which all the following conditions exist:

a) the items traded in the market are homogeneous;

b) willing buyers and sellers can normally be found at any time; and

c) prices are available to the public.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An asset is a resource:

a) controlled by an entity as a result of past events; and

b) from which future economic benefits are expected to flow to the entity.

Carrying amount is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated amortisation and accumulated impairment losses thereon.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 Share-based Payment.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

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.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

An intangible asset is an identifiable non-monetary asset without physical substance.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

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

The residual value of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

a) the period over which an asset is expected to be available for use by an entity; or

b) the number of production or similar units expected to be obtained from the asset by an entity.

Required Practice

Identifiability

12 An asset is identifiable if it either:

a) is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

RECOGNITION AND MEASUREMENT

21 An intangible asset shall be recognised if, and only if:

a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

b) the cost of the asset can be measured reliably.

22 An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that

represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

Internally generated goodwill

48 Internally generated goodwill shall not be recognised as an asset.

Research phase

Paragraph 54 and 63 below make it very clear that own generated goodwill, brands etc, and possibly assets arising out of research cannot be capitalised

54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

Development phase

Development expenditure that leads to an asset whose costs will be recovered from future inflows should be capitalised – but only if the criteria set out below are met.

57 An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

b) its intention to complete the intangible asset and use or sell it.

c) its ability to use or sell the intangible asset.

d) how the intangible asset will generate probable future economic benefits.

Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible

asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

63 Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

RECOGNITION OF AN EXPENSE

68 Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18–67); or

b) the item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, it forms part of the amount recognised as goodwill at the acquisition date (see IFRS 3).

Past expenses not to be recognised as an asset 71.

71 Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date.

MEASUREMENT AFTER RECOGNITION

72 An entity shall choose either the cost model in paragraph 74 or the revaluation model in paragraph 75 as its accounting policy. If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.

Cost model

74 After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Revaluation model

75 After initial recognition, an intangible asset shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

USEFUL LIFE

88 An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

INTANGIBLE ASSETS WITH FINITE USEFUL LIVES

Amortisation period and amortisation method

97 The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.

Residual value

Review of amortisation period and amortisation method

107 An intangible asset with an indefinite useful life shall not be amortised.

108 In accordance with IAS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount

a) annually, and

b) whenever there is an indication that the intangible asset may be impaired.

Review of useful life assessment

109 The useful life of an intangible asset that is not being amortised shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset.

RETIREMENTS AND DISPOSALS

112 An intangible asset shall be derecognised:

a) on disposal; or

b) when no future economic benefits are expected from its use or disposal.

DISCLOSURE

General

118 An entity shall disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

a) whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;

b) the amortisation methods used for intangible assets with finite useful lives;

c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;

d) the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included;

e) a reconciliation of the carrying amount at the beginning and end of the period.

Research and development expenditure

126 An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

The above paragraphs again illustrates the point that many IFRS's require potentially a LOT of disclosure

F Significant differences in GAAP

US GAAP

The definitions and approach to recognition and measurement is generally similar.

Unlike IAS 38 both internal research and development expenditure is expensed as incurred and intangible assets cannot be revalued.

UK GAAP

Goodwill arising from an acquisition is treated differently – see IFRS 3 Business combinations.

Amortisation

FRS 10 has a rebuttable presumption that intangible assets will have an economic life of 20 years (or less). IAS 38 does not have this presumption.

Both FRS 10 and IAS 38 permit an assumption of an indefinite life in which case the intangible asset will be subject to annual impairment reviews.

Development costs

SSAP 13 requires research (pure and applied) to be written off as incurred. This is the same as IAS 38. Under SSAP 13 development costs may but do not have to be capitalised. Under IAS 38 development costs have to be capitalised.

21
Impairment of assets – IAS 36

A Key points

- Assets both tangible and intangible can lose value.
- Depreciation or amortisation aims to systematically deal with loss of value as assets are consumed.
- Depreciation or amortisation is not always required and even when applied the rate of write down may be inadequate, thus such assets should be checked annually to identify if they are 'impaired'.

B What does the IAS contain?

C Why needed

With the requirement to include goodwill and other intangibles as assets in the balance sheet there is a need to have some 'science' as to how these are valued, particularly as by nature their value is 'intangible'. This

Standard aims to provide the framework for prudently valuing goodwill, intangibles and also tangible fixed assets.

D Ideas – concepts

After acquisition the net book amount, or carrying value, at which fixed assets, both tangible and intangible, are recorded in the balance sheet is the cost or valuation (fair value) less depreciation or amortisation to date.

The concept of depreciating or amortising fixed assets aims to fairly record the consumption of the asset over its useful life as economic benefit (income) is generated by the assets. The setting of the life of the assets and the method of deprecation is done as fairly as possible at the outset, but the process is subjective and business conditions do change with time, sometimes quite significantly in a very short time.

The carrying or book amount of the fixed assets may not be in line with the assets 'value to the business – that is the assets' ability to generate future cash flows. If the value to the business is higher then the fixed asset shown in the balance sheet is undervalued – that is prudent. However, if the value to the business is lower than the book or carrying amount then the fixed asset's value has been impaired – the value should be written down to the lower, more realistic and prudent amount.

A review for impairment of a fixed asset or goodwill should be carried out if events or changes in circumstance, indicate that the carrying amount of the fixed asset or goodwill, may not be recoverable.

The concept of recoverable amount

A prudent value for an asset would be the net disposal proceeds if it was sold, this would be the recoverable amount. However, it is obvious that simply to sell an asset would often mean getting 'scarp value' for it. The asset has a higher value if it continues in use. A means of determining this value in use is to identify the cash flows arising from the assets productive use and to discount them back to a present value. This is the value in use.

E Key Content of the Standard

Objective

The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

Definitions

An active market is a market in which all the following conditions exist:

a) the items traded within the market are homogeneous;

b) willing buyers and sellers can normally be found at any time; and

c) prices are available to the public.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

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.

Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Depreciation (Amortisation) is the systematic allocation of the depreciable amount of an asset over its useful life.

Fair value less costs to sell is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

An impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.

The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.

Useful life is either:

a) the period of time over which an asset is expected to be used by the entity; or

b) the number of production or similar units expected to be obtained from the asset by the entity.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

Required Practice

IDENTIFYING AN ASSET THAT MAY BE IMPAIRED

9 An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

10 Irrespective of whether there is any indication of impairment, an entity shall also:

a) test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recov-

erable amount. This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period.

b) test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80–99.

12 In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External sources of information

a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

d) the carrying amount of the net assets of the entity is more than its market capitalisation.

Internal sources of information

e) evidence is available of obsolescence or physical damage of an asset.

f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

13 The list in paragraph 12 is not exhaustive.

MEASURING RECOVERABLE AMOUNT

Value in use

30 The following elements shall be reflected in the calculation of an asset's value in use:

a) an estimate of the future cash flows the entity expects to derive from the asset;

b) expectations about possible variations in the amount or timing of those future cash flows;

c) the time value of money, represented by the current market risk-free rate of interest;

d) the price for bearing the uncertainty inherent in the asset; and

e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Basis for estimates of future cash flows 33–38

33 In measuring value in use an entity shall:

a) base cash flow projections on reasonable and supportable assumptions.

b) base cash flow projections on the most recent financial budgets/forecasts approved by management.

c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified.

Composition of estimates of future cash flows

39 Estimates of future cash flows shall include:

a) projections of cash inflows from the continuing use of the asset;

b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

44 Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

a) a future restructuring to which an entity is not yet committed; or

b) improving or enhancing the asset's performance.

50 Estimates of future cash flows shall not include:

a) cash inflows or outflows from financing activities; or

b) income tax receipts or payments.

Discount rate

55 The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of:

a) the time value of money; and

b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.

RECOGNISING AND MEASURING AN IMPAIRMENT LOSS 58–64

59 If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.

60 An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in IAS 16). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.

62 When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another Standard.

CASH-GENERATING UNITS AND GOODWILL

Identifying the cash-generating unit to which an asset belongs

66 If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

Recoverable amount and carrying amount of a cash-generating unit

75 The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.

REVERSING AN IMPAIRMENT LOSS

110 An entity shall assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.

DISCLOSURE

126 An entity shall disclose the following for each class of assets:

a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of comprehensive income in which those impairment losses are included.

b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the statement of comprehensive income in which those impairment losses are reversed.

c) the amount of impairment losses on revalued assets recognised in other comprehensive income during the period.

d) the amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.

Estimates used to measure recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives 134–137.

F Significant differences in GAAP

US GAAP

The principal of writing down where impairment is identified is similar.

There are considerable differences in the detailed definitions and the level at which testing may be done. For example, goodwill is allocated to reporting units (RUs) that are expected to benefit from the synergies of the business combination from which it arose. An RU is defined as an operating segment or one level below an operating segment.

The cash flows used to assess recoverability are not discounted.

The revaluation of property, plant and equipment and intangible assets is not permitted; therefore all impairment losses are recognised in profit and loss.

UK GAAP

Under both FRS 11- Impairment of fixed assets and goodwill and IAS 36 impairment is measured by comparing the carrying value of fixed assets and goodwill with the higher of the fair value (less costs to sell) i.e. the net selling price and value in use.

FRS 11 suggests amortising goodwill over a period of 20 years or less if there is a finite life (e.g. a license agreement). Goodwill can be carried at cost indefinitely but then an annual impairment review is required.

Under FRS 11 impairment losses are allocated first to good will, then to intangible assets and then to other tangible fixed assets. Under IAS 36 losses are allocated first to goodwill and then pro rata to intangible and tangible fixed assets.

FRS 11 permits reversals of impairment in restricted circumstances. FRS 11 requires impairment losses caused by the consumption of economic benefits to be recognised in the P&L account. IAS 36 requires the impairment losses to be recognised in the P&L account only to the extent that they exceed any past revaluation reserve related to the asset that is impaired.

22
Inventories/Stock – IAS 2

A Key points

- Stocks or now more commonly 'inventories' are often very material assets.
- Inventories can deteriorate, become obsolete or be stolen.
- An increase in inventory value decreases cost of sales and thus increases profit (and vice versa).
- Inventory valuation is often critical.

B What does the IAS contain?

- Techniques for the measurement of cost 21–22
- Cost formulas 23–27
- Net realisable value 28–33
- RECOGNITION AS AN EXPENSE 34–35
- DISCLOSURE 36–39

C Why needed

Over (or under) valuing inventory (stock) affects the balance sheet asset value. BUT the valuation also affects the related cost of sales, and thus profit by the same amount. If one wanted to manipulate profit then stock valuation would be an obvious choice.

Inventories (stocks) are so critical to the reporting of profits or losses at the correct amount, in the correct period, that clear definition of terms and defined accounting is required. The costs to be included, the condition, saleability, and thus value of stocks, will often be subjective. There is ample scope for errors or manipulation of figures!

D Ideas – concepts

The basic concept is that inventories / stock / WIP should be included in accounts at cost (what was paid for them) or a lower figure, net realisable value, if they are now worth less. The exercise of counting or taking stock at the end of an accounting period is the matching concept in action. A simple example of the arithmetic of the stock adjustment is shown below.

- materials purchased in the period 8,500
- stock held at the end of the period 800
- therefore materials sold or taken into production in the period 7,700

A question arises over what figure to use for the value of stock. In the simple example above, the conventional and normally correct figure is

the cost of the remaining stock. Stock or WIP should be valued at what it cost. However, if for some reason the stock on hand had deteriorated, or could be replaced at a (permanently) much lower price, then the stock should be written down to its net realisable value (nrv). This is the prudence concept in operation.

E Key Content of the Standard

Objective

The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Definitions

Inventories are assets:

a) held for sale in the ordinary course of business;

b) in the process of production for such sale; or

c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net realisable value is 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.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Required Practice

MEASUREMENT OF INVENTORIES

9 Inventories shall be measured at the lower of cost and net realisable value.

Cost of inventories

10 The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Cost formulas

23 The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.

25 The cost of inventories, other than those dealt with in paragraph 23, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

RECOGNITION AS AN EXPENSE

34 When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs.

DISCLOSURE

36 The financial statements shall disclose:

a) the accounting policies adopted in measuring inventories, including the cost formula used;

b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;

c) the carrying amount of inventories carried at fair value less costs to sell;

d) the amount of inventories recognised as an expense during the period;

e) the amount of any write-down of inventories recognised as an expense in the period in accordance with paragraph 34;

f) the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period in accordance with paragraph 34;

g) the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34; and

h) the carrying amount of inventories pledged as security for liabilities.

F Significant differences in GAAP

US GAAP

The principle of valuing inventories (stock) prudently is the same. However US GAPP states inventories are measured at the lower of cost and market where "market" means: replacement cost limited by net realisable value (ceiling) and net realisable value less a normal profit margin (floor). Also the cost of inventory can be determined using the LIFO method in addition to the FIFO or weighted average method.

The same cost formula need not be applied to all inventories having a similar nature and use to the entity.

Under US GAAP a write-down of inventory to market is not reversed for subsequent recoveries in value.

UK GAAP

SSAP 9 is very similar – both require inventories – stock to be measured at the lower of cost and net realisable value.

IAS 2 requires that an entity must use the same cost formula for all inventories having a similar nature. This is not specifically stated in SSAP9 but implied under the concept of consistency – FRS 18.

23
Construction contracts/ Long term WIP – IAS 11

A Key points

- Construction contract assets are often material amounts in balance sheets.
- Changes in valuation of work in progress (WIP) have a direct profit and loss effect.
- Identifying the stage of completion of a long-term construction project may be difficult.

B What does the IAS contain?

C Why needed

Construction projects or more generically work in progress (WIP) figures, are often a material balance sheet asset and also critical to the reporting of profits or losses at the correct amount and in the correct period. Clear definition of terms with clearly defined accounting is required.

The aim of the Standard is to ensure that work in progress is valued prudently with correct matching of revenue and costs.

Work in progress values affect both the balance sheet asset value and the related cost of sales. If you wanted to manipulate profit (and assets) then WIP valuation would be an obvious choice. For a construction contract one or all of the following may be highly subjective:

- The costs to be included.
- The stage of completion.
- Realisability of the work.

Thus the value of WIP is very often subjective. There is ample scope for manipulating figures!

D Ideas – concepts

The basic concept is that costs of work done should be matched in an accounting period with the related income (or putative income), and a resultant profit or loss measured. Any costs of valuable work done and not matched by income should be carried in the balance sheet as WIP.

If you wait till the final completion and signing off of a contract or project then the profit or loss can be accurately determined. However, there is a need to calculate what profit (or loss) is being made as a project progresses. For statutory reporting purposes, it is necessary to report the profit

earned in a year and the resultant asset/liability position at the balance sheet date.

A common term used in the context of contract or project sales or profits is 'earned value'. An issue with the Standard is that general principles are described but not the detailed assessment of profit (or margin) earned. The detailed definitions and calculations of 'earned value', attributable profit etc., vary considerably among companies but the principles of the measure, its calculation and uses are as follows.

The Standard has examples of construction contract profit and WIP calculations in appendix A.

E Key Content of the Standard

Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Standard uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of comprehensive income. It also provides practical guidance on the application of these criteria.

Definitions

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

Required Practice

COMBINING AND SEGMENTING CONSTRUCTION CONTRACTS

8 When a contract covers a number of assets, the construction of each asset shall be treated as a separate construction contract when:

a) separate proposals have been submitted for each asset;

b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

c) the costs and revenues of each asset can be identified.

CONTRACT REVENUE

11 Contract revenue shall comprise:

a) the initial amount of revenue agreed in the contract; and

b) variations in contract work, claims and incentive payments:

i) to the extent that it is probable that they will result in revenue; and

ii) they are capable of being reliably measured.

CONTRACT COSTS

16 Contract costs shall comprise:

a) costs that relate directly to the specific contract;

b) costs that are attributable to contract activity in general and can be allocated to the contract; and

c) such other costs as are specifically chargeable to the customer under the terms of the contract.

RECOGNITION OF CONTRACT REVENUE AND EXPENSES

22 When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.

23 In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

a) total contract revenue can be measured reliably;

b) it is probable that the economic benefits associated with the contract will flow to the entity;

c) both the contract costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably; and IAS 11;

d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

24 In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

a) it is probable that the economic benefits associated with the contract will flow to the entity; and

b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

RECOGNITION OF EXPECTED LOSSES

32 When the outcome of a construction contract cannot be estimated reliably:

a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and

b) contract costs shall be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.

DISCLOSURE

39 An entity shall disclose:

a) the amount of contract revenue recognised as revenue in the period;

b) the methods used to determine the contract revenue recognised in the period; and

c) the methods used to determine the stage of completion of contracts in progress.

IAS 11/IAS 18 – the future

Frankly UK GAAP and IFRS as they exist are pretty lax on how revenue and profit might be recognised – this is an area for considerable change – probably in 2011.

F Significant differences in GAAP

US GAAP

Under US GAAP construction contract revenue recognition and balance sheet asset/liability amounts could be similar, but much depends on the entity specific detailed accounting policies.

UK GAAP

Both IAS 11 and SSAP 9 Stocks and long term contracts use the 'percentage of completion' method to recognise revenue and expense. IAS 11 uses the method where the outcome of the contract can be estimated reliably, SSAP9 implies the use of more prudence – recognising 'prudently calculated attributable profit.

Both standards require zero profit to be recognised where outcome is uncertain.

Because of UK company law presentation differs under UK GAAP. The amount due for WIP is shown split between debtors (amounts recoverable on contracts) and WIP (long term contact balances). IAS 11 shows one gross amount due from customers for contract work.

24
Leases – off balance sheet finance – IAS 17

A Key points

- "Off balance sheet" finance or not?
- A lease gives the lessor the right to the use of an asset over time but equally a contra liability to have to make payments over time.
- Is there simply a 'pay as you go' rental situation or something more complex?
- An operating lease assumes you pay as you use an asset – there are no material balance sheet implications.
- A finance lease deems you own the asset but also have a contra liability – the lease is not "off balance sheet"

B What does the IAS contain?

C Why needed

Many businesses obtain use of assets through leases and hire purchase agreements. If a company showed leased asset costs as an expense then profits would be lower, but there would be neither assets nor the contra liabilities on the balance sheet. Capital employed would be lower and the corollary would be that there would be no financing shown – less money borrowed by the company. This is an example of 'off-balance sheet finance'. Liabilities could be hidden, gearing would appear lower and performance measures distorted.

D Ideas – concepts

The Standard is based on the concept of 'substance over form' and thus requires that leased assets be brought onto the balance sheet along with

the contra liability. Assets leased, hired or rented for a fixed, non-cancelable period equivalent to their useful lives are in substance purchased assets.

The bank or finance house financing the asset certainly does not consider it owns an asset, but rather that it has a debtor – a loan repayable over time. The bank is merely a financial intermediary. Would the bank manager be happy if a business returned its fleet of leased dumper trucks and left them on the doorstep?

The business has purchased and will use the assets for all of, or the best part of, their useful lives. These assets are capital employed of the business. But possibly more significant is the fact that the business has irrevocably committed to make, for example, say 36 monthly payments – they have in effect a 3 year loan. This commitment – liability should be shown. This is borrowed capital invested in the business.

E Key Content of the Standard

Objective

1 The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

Definitions

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An operating lease is a lease other than a finance lease.

A non-cancellable lease is a lease that is cancellable only:

a) upon the occurrence of some remote contingency;

b) with the permission of the lessor;

c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease.

As at this date:

a) a lease is classified as either an operating or a finance lease; and

b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (i.e. the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).

The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or

b) for a lessor, any residual value guaranteed to the lessor by:

   i) the lessee;

   ii) a party related to the lessee; or

iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Economic life is either:

a) the period over which an asset is expected to be economically usable by one or more users; or

b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Guaranteed residual value is:

a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

Gross investment in the lease is the aggregate of:

a) the minimum lease payments receivable by the lessor under a finance lease, and

b) any unguaranteed residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between:

a) the gross investment in the lease, and

b) the net investment in the lease.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).

Required Practice

CLASSIFICATION OF LEASES

8 A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

Finance leases

Initial recognition

20 At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset.

Subsequent measurement

25 Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rents shall be charged as expenses in the periods in which they are incurred.

27 A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with IAS 16 Property, Plant and Equipment and IAS 38 Intangible

Assets. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life.

Disclosures

There follows a comprehensive list of disclosures.

Operating leases

33 Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Disclosures

There follows a comprehensive list of disclosures.

LEASES IN THE FINANCIAL STATEMENTS OF LESSORS

Finance leases

Initial recognition

36 Lessors shall recognise assets held under a finance lease in their statements of financial position and present them as a receivable at an amount equal to the net investment in the lease.

Subsequent measurement

39 The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.

Disclosures

There follows a comprehensive list of disclosures.

Operating leases

49 Lessors shall present assets subject to operating leases in their statements of financial position according to the nature of the asset.

50 Lease income from operating leases shall be recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

52 Initial direct costs incurred by lessors in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

53 The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with IAS 16 and IAS 38.

Disclosures

Again, there follows a comprehensive list of disclosures.

The future

This standard has been under review for some time and may at last be replaced in 2011. A July 2009 discussion paper clearly sets out the problems and the direction the revised (and converged) standard is likely to take.

Discussion Paper Leases Preliminary Views

Comments to be received by 17 July 2009

Criticisms of the existing accounting model

1.12 The existing accounting model for leases has been criticised for failing to meet the needs of users of financial statements. In particular:

a) many users think that operating leases give rise to assets and liabilities that should be recognised in the financial statements of lessees. Consequently, users routinely adjust the recognised amounts in an attempt to recognise those assets and liabilities and reflect the effect of lease contracts in profit or loss. However, the information available to users in the notes to the financial statements is insufficient for them to make reliable adjustments to the recognised amounts.

b) the existence of two very different accounting models for leases (the finance lease model and the operating lease model) means that similar transactions can be accounted for very differently. This reduces comparability for users.

c) the existing standards provide opportunities to structure transactions so as to achieve a particular lease classification. If the lease is classified as an operating lease, the lessee obtains a source of unrecognised financing that can be difficult for users to understand.

1.13 Preparers and auditors have criticised the existing model for its complexity. In particular, it has proved difficult to define the dividing line between finance leases and operating leases in a principled way. Consequently, the standards use a mixture of subjective judgements and 'bright-line' tests that can be difficult to apply.

1.14 Some have argued that the existing accounting model is conceptually flawed. In particular:

a) on entering a lease contract, the lessee obtains a valuable right (the right to use the leased item). This right meets the boards' definitions of an asset. Similarly, the lessee assumes an obligation (the obligation to pay rentals) that meets the boards' definitions of a liability. However, if the lessee classifies the lease as an operating lease, that right and obligation are not recognised.

b) there are significant and growing differences between the accounting model for leases and other contractual arrangements. This has led to inconsistent accounting for arrangements that meet the definition of a lease and similar arrangements that do not.

A new approach – Preliminary views

3.26 On the basis of the preceding analysis, the boards tentatively concluded that the existing lease accounting model is inconsistent with the asset and liability definitions in the Framework and CON 6. The boards tentatively decided to develop a new approach to accounting for leases that would result in the recognition of the assets and liabilities identified as arising in a lease contract. Rather than treating some lease contracts like a purchase of the leased item (finance leases) and others as executory contracts (operating leases), the new approach would treat all lease contracts as the acquisition of a right to use the leased item for the lease term. Thus, the lessee would recognise the following:

a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)

b) a liability for its obligation to pay rentals.

F Significant differences in GAAP

US GAAP

The overall principles are similar but US GAAP has more specific and detailed rules.

US GAAP does not permit immediate recognition of a gain on sale and leaseback transactions unless the leaseback is considered to be "minor".

There is no explicit requirement that a series of linked transactions in the legal form of a lease be accounted for based on the substance of the arrangement.

UK GAAP

The real weakness in SSAP 21 is the definition of a finance lease – the 90% rule. That is substantially all (the 90% figure) of the present value of minimum lease payments are 90% or more of the fair value of the leased asset. This is often seen as a hurdle to come below.

IAS 17 makes no reference to the percentage of fair value that needs to be included in the minimum lease payments but rather provides many examples which if followed (as they ought) would ensure most leases have to be classified as finance leases.

This may be the reason that on adoption of IFRS we have seen increases in the number of leased assets coming onto the balance sheet.

25
Provisions, contingent liabilities and contingent assets – IAS 37

A Key points

- Liabilities should be recognised as a cost and a liability.
- Possible but remote liabilities (contingent liabilities) should be disclosed.
- Unnecessary provisions should not be set up to lower or hide profits.
- Possible but remote assets (contingent assets) should be disclosed.

B What does the IAS contain?

C Why needed

To 'legally' move profits from one accounting period to another would be a very useful facility. Reported results could be in line with promised results, profits could be smoothed, losses minimised, tax charges managed and so on. The setting up and releasing of ill defined provisions could facilitate such practices.

This was one of the great 'creative accounting' practices of the past.

An example of the abuse of making un-needed provisions is as follows:

- Many companies, particularly those involved in takeovers would 'over-provision' when profits were high and often equally when there were losses, make the situation really bad. They would take a 'hit' to profits or disclose a high level of losses.
- The promise would be increasing profits in the future once all the problems from previous deficient management had been overcome. It would not really matter whether or not the new team was as good as they claimed. There would be the high, un-needed and unused provisions to release, thus guaranteeing the promised profits (for a while at least!).
- The Standard accepts the business and commercial need for provisions but brings definition as to when and how provisions should be sanctioned. The Standard demands a high degree of certainty as to cause and amount before provisions can be made.
- The objective of the Standard is to ensure appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets, and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

D Ideas – concepts

An inherent trait of accountants is to be prudent, that is to fully anticipate all likely business costs and related liabilities whenever arising. This approach has its merits and those that are imprudent in business and accounting may not survive. Proper account should be taken of all existing and likely events and costs.

Costs and liabilities are a worry to a business – they mean that there will be an outflow of cash or depletion of other assets. Inherent caution or prudence would dictate that all reasonable, likely liabilities are recognised – a cost incurred now and a liability (provision) recognised in the balance sheet.

The prime issue that the Standard aims to address is that whilst convention and practice often dictates what is 'prudent' there is a legitimately wide range of what may be deemed 'prudent'. Costs and related liabilities should only be recognised where there is likely to be a cost and/or payment related to the event which has or will occur. Without definition and guidance too much or too little may be provided.

E Key Content of the Standard

Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

Definitions

A provision is a liability of uncertain timing or amount.

A liability is 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.

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A legal obligation is an obligation that derives from:

a) a contract (through its explicit or implicit terms);

b) legislation; or

c) other operation of law.

A constructive obligation is an obligation that derives from an entity's actions where:

a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A contingent liability is:

a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

b) a present obligation that arises from past events but is not recognised because:

   i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

   ii) the amount of the obligation cannot be measured with sufficient reliability.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

A restructuring is a programme that is planned and controlled by management, and materially changes either:

a) the scope of a business undertaken by an entity; or

b) the manner in which that business is conducted.

Required Practice

Provisions and other liabilities

11 Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement.

Relationship between provisions and contingent liabilities

12 In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term 'contingent' is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

13 This Standard distinguishes between:

a) provisions – which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

b) contingent liabilities – which are not recognised as liabilities because they are either:

i) possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

ii) present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

The above paragraphs aim to enhance understanding of provisions and the distinction between provisions and contingent liabilities

RECOGNITION

14 A provision shall be recognised when:

a) an entity has a present obligation (legal or constructive) as a result of a past event;

b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

It is very important that there is an obligation (or constructive obligation) – an obligating event, otherwise no provision can be made. This is to prevent un-needed or creative provisions.

Present obligation

15 In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

Past event

17 A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event.

18 Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's statement of financial position are those that exist at the end of the reporting period.

This effectively presents unspent budgets being carried forward to the next year.

Contingent liabilities

27 An entity shall not recognise a contingent liability.

28 A contingent liability is disclosed, as required by paragraph 86, unless the possibility of an outflow of resources embodying economic benefits is remote.

MEASUREMENT

Best estimate

36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Risks and uncertainties

42 The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

Present value

45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

Future events

48 Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Although paragraphs 45 and 46 require the discounting (possible considerable reduction) of future liabilities paragraph 48 requires that future events, for example inflation in costs should be taken into account.

CHANGES IN PROVISIONS

59 Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.

USE OF PROVISIONS

61 A provision shall be used only for expenditures for which the provision was originally recognised.

APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES 63–83

Future operating losses

63 Provisions shall not be recognised for future operating losses.

Paragraphs 61 and 63 are clear statements that provisions should only exist where there is a specific and defined liability to cover a committed past or present event.

Onerous contracts

66 If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

Restructuring

72 A constructive obligation to restructure arises only when an entity:

a) has a detailed formal plan for the restructuring identifying at least:

i) the business or part of a business concerned;

ii) the principal locations affected;

iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

iv) the expenditures that will be undertaken; and

v) when the plan will be implemented; and

b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

DISCLOSURE

84 For each class of provision, an entity shall disclose:

a) the carrying amount at the beginning and end of the period;

b) additional provisions made in the period, including increases to existing provisions;

c) amounts used (i.e. incurred and charged against the provision) during the period;

d) unused amounts reversed during the period; and

e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required.

There follows a list of further possible disclosures.

92 In extremely rare cases, disclosure of some or all of the information required by paragraphs 84–89 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

The Future

The IASB issued and exposure draft Measurement of Liabilities in IAS 37 in January 2010 after public comment has been received and analysed it is proposed to issue a revised and more converged standard at the end of 2010.

Practice relating to provisioning for a business restructuring will be converged and practice and guidance on measurement of liabilities refined. The core principles will not change.

F Significant differences in GAAP

US GAAP

The basic principles are the same but there are differences in detail which can well lead to different amounts recognised – hence the exposure draft mentioned above.

Apart from differences in US and UK English you do have to wonder if there is a conspiracy to be different! e.g. in IFRS "probable" means "more likely than not" and in US GAAP "probable" means "likely to occur".

UK GAAP

FRS 12 with the same title and IAS 37 was developed simultaneously and there are no significant differences.

26
Statement of cash flows – (cash flow statements) – IAS 7

As a result of the changes in terminology made by IAS 1 in 2007, the title of IAS 7 was changed to Statement of Cash Flows.

A Key points

- "Cash is king."
- How cash flows into and out of a business tells a lot about the business.
- Cash flow analysis should support the story the income statement and balance sheet reveal.
- Cash flow statements may point to where a business is heading.

B What does the IAS contain?

C Why needed

Positive cash flow is essential for the survival and growth of any business. The balance sheet can tell you where you are, the income statement can tell you what income and expenditure there was (these include accrued amounts), but only a cash flow statement can tell you what (if any) cash is being generated, how it is being sourced and how it's used.

Identifying how cash has flown through a business is very useful in verifying a businesses performance for a period and movement in net asset position over a period.

After the debacle of Worldcom, Enron etc. credit analysts woke up to the fact that maybe they had not been doing their job. On quizzing the CEO of a reputable company about whether reported profits were real he replied *'lift the hatch and the dollars are there'* – a good retort!

D Ideas – concepts

The majority of business transactions are cash based, that is cash, or more likely bank account, receipts and payments are involved. Thus a statement could be prepared listing cash in and cash out, grouped into:

- Cash in and out from trading, from operating activities.
- Cash out into investments or fixed assets, or in from the sale of the same – investing activities.
- Cash in from raising new equity or loans, or out from the reduction in loans or equity – financing activities.

These headings cover all the activities that a business can get involved in and the net cash in or out will be the change in the net cash position* over the period. *(Cash on hand, deposited at a bank or overdraft.)

A cash flow statement simply groups cash flows as follows:

- Cash flows from operating activities.
- Cash flows from investing activities.
- Cash flows from financing activities.
- Net increase (/decrease) in cash and cash equivalents.

The cash flow statement could be prepared from the cash book and bank accounts. This would show gross receipts from customers, payments to suppliers and employees, payments for the purchase of fixed assets and proceeds of long-term borrowings etc. This would reveal the basic cash flows by type and is called the direct method. This is the method preferred by the Standard, but rarely followed. The drawbacks are that there is no clear reconciliation with operating profit and detailed cash and bank analysis has to be done.

The indirect method arrives at the cash flow headings above by starting with operating profit which has non-cash figures (e.g. accruals and depreciation) along with movements in working capital (e.g. money tied up in stock) added back to give the operating cash flow. There is thus reconciliation between operating profit reported in the income statement and operating cash flow. This can be shown on the face of the cash flow statement or as a note.

The investing and financing cash flows can be identified by analyzing the movement in balance sheet figures, e.g. fixed assets additions are an investing cash out flow.

Cash flow statements are in essence simple to prepare using the indirect method. For a successful company this would mean the movement in cash and bank balances can be explained by cash inflows from operation of the business, less outflows on investment plus inflows from funding through loans or equity. There is an example of the layout and preparation of a cash flow statement in chapter 43.

E Key Content of the Standard

Objective

Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation. The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.

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 long-term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Required Practice

BENEFITS OF CASH FLOW INFORMATION

4 A statement of cash flows, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

5 Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

5 above is where it is suggested looking at past cash flows may have help with prediction – this may well be true where an entity has consistent and certain cash flows.

PRESENTATION OF A STATEMENT OF CASH FLOWS

10 The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities.

Operating activities

14 Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss.

REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

18 An entity shall report cash flows from operating activities using either:

a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

b) the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

Although the standard and theorists would prefer a – the direct method is used, in practice nearly everyone uses the indirect method.

FOREIGN CURRENCY CASH FLOWS

25 Cash flows arising from transactions in a foreign currency shall be recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.

26 The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows.

INTEREST AND DIVIDENDS

31 Cash flows from interest and dividends received and paid shall each be disclosed separately. Each shall be classified in a consistent manner from period to period as either operating, investing or financing activities.

TAXES ON INCOME

35 Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

NON-CASH TRANSACTIONS

43 Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

COMPONENTS OF CASH AND CASH EQUIVALENTS

45 An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.

OTHER DISCLOSURES

48 An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.

F Significant differences in GAAP

US GAAP

Cash receipts and payments with attributes of more than one class of cash flows are classified based on the predominant source of the cash flows unless the underlying transaction is accounted for as having different components. Unlike IFRS 'cash' does not include bank overdrafts.

UK GAAP

The layout is significantly different from IAS – there are 8 or 9 prescribed headings as opposed to the 3 headings required by IAS 7.

27
Business combinations – IFRS 3

A Key points

- When businesses are taken over or merged there are many possible ways of accounting.
- Mergers are banned – it is considered there will always be a dominant acquirer.
- Up to date and fair values have to be used for the acquired entity's assets.

B What does the IAS contain?

C Why needed

The majority of business combinations are the result of one entity bidding for and taking over another entity – one entity purchases another.

This Standard requires all business combinations to be accounted for by applying the purchase method – acquisition accounting. The Standard setters require that an acquirer be identified – they state that there is no such thing as a merger or combining of interests.

Acquired assets should be disclosed at "fair value" on acquisition and any goodwill arising recognised as an asset in the balance sheet. Goodwill is to remain in the balance sheet at cost subject to any write down required as a result of a normally annual test for impairment. Acquisition accounting is the one acceptable method.

It is feasible that two businesses could combine their interests and merge. So why do the Standard setters deny the possibility? Merger accounting allows net assets to be combined at their (historical) values as per individual companies' accounts. Since neither takes over the other no revision of the combined assets to fair value is needed and no goodwill arises. The combined business balance sheet is likely to have out of date and understated net assets – this offends the Standard setters. Pooling of interests or merger accounting has for some time not been permitted in the US, Australia and other countries, and thus an important reason for the issuing of this standard is to achieve convergence.

D Ideas – concepts

Acquisition accounting and Goodwill

The concept is that there will always be one company taking over another. Fair values should be assigned to the acquired company's assets and any premium paid above this amount is goodwill arising on acquisition. This goodwill is an asset that as been paid for either with cash or by share issue. Goodwill is the generic term. Specific examples of what underlies goodwill are trade names, brands, patents, customer base and know how, or a good management team. The Standard requires that goodwill is shown as an asset and any write downs (impairments) are charged to the income statement. This standard is one of several that pursue the move to make balance sheets more valuation statements – balance sheets with more up to date values.

Goodwill will remain in the balance sheet at cost. This implies that the name, brand, patents or whatever constituted the goodwill will be supported, by say advertising or development costs. However if goodwill and other intangibles are not supported or become out of date or obsolete then the assets are considered to be impaired.

The Standard does not permit calculation and recognition of appreciation in the value of goodwill – are the Standard setters being too prudent or are they preventing the opening of a Pandora's box of spurious revaluations? Goodwill is the most elusive of all business assets.

Mergers

If merger accounting was allowed the combined business balance sheet would have out of date and understated net assets – this offends the Standard setters. Another argument in favour of disallowing merger accounting is the fact that there are probably very few cases, at least of listed companies, where there is a true merger. There will always be a "take-over" of one business by the other.

E Key Content of the Standard

Objective

1 The objective of this IFRS is to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statement about a business combination and its effects. To accomplish that, this IFRS establishes principles and requirements for how the acquirer:

a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;

b) recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and

c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

Definitions

Acquiree. The business or businesses that the acquirer obtains control of in a business combination.

Acquirer. The entity that obtains control of the acquiree.

Acquisition date. The date on which the acquirer obtains control of the acquiree.

Business. 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.

Business combination. A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations as that term is used in this IFRS.

Contingent consideration. Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

Control. The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Equity interests. For the purposes of this IFRS, equity interests is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of mutual entities.

Fair value. The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Goodwill. An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Identifiable. An asset is identifiable if it either:

a) is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Intangible asset. An identifiable non-monetary asset without physical substance.

Mutual entity. An entity, other than an investor-owned entity, that provides dividends, lower costs or other economic benefits directly to its

Owners, members or participants. For example, a mutual insurance company, a credit union and a co-operative entity are all mutual entities.

Non-controlling interest. The equity in a subsidiary not attributable, directly or indirectly, to a parent.

Owners. For the purposes of this IFRS, owners is used broadly to include holders of equity interests of investor-owned entities and owners or members of, or participants in, mutual entities.

Required Practice

IDENTIFYING A BUSINESS COMBINATION

3 An entity shall determine whether a transaction or other event is a business combination by applying the definition in this IFRS, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. Paragraphs B5–B12 provide guidance on identifying a business combination and the definition of a business.

THE ACQUISITION METHOD

4 An entity shall account for each business combination by applying the acquisition method.

5 Applying the acquisition method requires:

a) identifying the acquirer;

b) determining the acquisition date;

c) recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

d) recognising and measuring goodwill or a gain from a bargain purchase.

Identifying the acquirer 6–7

6 For each business combination, one of the combining entities shall be identified as the acquirer

There will ALWAYS be a 'takeover' – mergers are not allowed.

Determining the acquisition date 8–9

The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

Recognition principle

10 As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.

Recognition conditions

Classifying or designating identifiable assets acquired and liabilities assumed in a business combination

15 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other IFRSs subsequently. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date.

Measurement principle

18 The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

Fair values (up to date values) must be used

Recognising and measuring goodwill or a gain from a bargain purchase

32 The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:

a) the aggregate of:

i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);

ii) the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and

iii) in a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

SUBSEQUENT MEASUREMENT AND ACCOUNTING

54 In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable IFRSs for those items, depending on their nature. However, this IFRS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:

a) reacquired rights;

b) contingent liabilities recognised as of the acquisition date;

c) indemnification assets; and

d) contingent consideration.

DISCLOSURES

59 The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:

a) during the current reporting period; or

b) after the end of the reporting period but before the financial statements are authorised for issue.

61 The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.

F Significant differences in GAAP

US GAAP

From July 2009 the US and IFRS standards are virtually converged.

UK GAAP

The UK standard FRS 2 requires exclusion from consolidation where severe long term restrictions hinder effective control. IAS 27 does not have such an exclusion.

Under FRS 2 goodwill previously written off to reserves is included in the calculation of a gain or loss on disposal. IAS 27 excludes from the calculations goodwill previously written off to equity.

28
Consolidated and separate financial statements – IAS 27

A Key points

- This standard (in conjunction with IFRS 3 Business combinations) sets out how to consolidate.
- It sets out what has to be presented and disclosed in consolidated accounts.
- It sets out what has to be presented and disclosed in the parent's (holding company's) accounts.

B What does the IAS contain?

- ACCOUNTING FOR INVESTMENTS IN SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES IN SEPARATE FINANCIAL STATEMENTS 38–40
- DISCLOSURE

C Why needed

This standard ties in with IFRS 3 as it sets out when and under what criteria consolidated and separate (parent company) accounts should be produced.

Without definition of control either on purchase or sale of a company results in the year of acquisition/disposal could be manipulated.

D Ideas – concepts

Clearly defined criteria for control and loss of control need to be set.

E Key Content of the Standard

Objective

IN4 The objective of IAS 27 is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its separate financial statements and in its consolidated financial statements for a group of entities under its control. The Standard specifies:

a) the circumstances in which an entity must consolidate the financial statements of another entity (being a subsidiary);

b) the accounting for changes in the level of ownership interest in a subsidiary;

c) the accounting for the loss of control of a subsidiary; and

d) the information that an entity must disclose to enable users of the financial statements to evaluate the nature of the relationship between the entity and its subsidiaries.

Definitions

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

A group is a parent and all its subsidiaries.

Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

A parent is an entity that has one or more subsidiaries.

Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

Required Practice

PRESENTATION OF CONSOLIDATED FINANCIAL STATEMENTS

9 A parent, other than a parent described in paragraph 10, shall present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with this Standard.

10 A parent need not present consolidated financial statements if and only if:

a) the parent is itself a wholly-owned subsidiary, or 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;

b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

CONSOLIDATION PROCEDURES

22 The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as of the same date. When the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent unless it is impracticable to do so.

24 Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

27 Non-controlling interests shall be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

30 Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions (i.e. transactions with owners in their capacity as owners).

ACCOUNTING FOR INVESTMENTS IN SUBSIDIARIES

38 When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:

a) at cost, or

b) in accordance with IAS 39.

JOINTLY CONTROLLED ENTITIES AND ASSOCIATES IN SEPARATE FINANCIAL STATEMENTS

40 Investments in jointly controlled entities and associates that are accounted for in accordance with IAS 39 in the consolidated financial statements shall be accounted for in the same way in the investor's separate financial statements.

DISCLOSURE

There is a comprehensive list of possible disclosures.

F Significant differences in GAAP

US GAAP

There are issues arising from US GAAP using a 'power to control model' or a de facto control model (as in IFRS). There is no de facto control model under U.S. GAAP.

Under US GAAP potential voting rights are not considered in assessing control for non-variable interest entities.

As for IFRS generally all subsidiaries are consolidated, however there are limited exceptions in certain specialised industries

There will be differences in practice as to the layout of consolidated and separate US financial statements.

UK GAAP

UK FRS 2 does not deal with the treatment of investments in subsidiaries in the parent's financial statements.

29
Accounting for investments in associates – IAS 28

A Key points

- An associate is a significant or material investment but it is not controlled by the investor.
- This Standard sets out how an investment in an associate should be valued.
- This Standard sets out how results of an associate should be disclosed.

B What does the IAS contain?

C Why needed

A company can own 7%, 24%, 38% etc. of another company or enterprise. The question is, how should the net assets and results of these different levels of ownership be accounted for? Without some definition the owners could include or exclude, net assets (or liabilities) and shares of profits or losses as they saw fit.

D Ideas – concepts

The issue to be addressed is how to account for substantial investments in other entities that are neither subsidiaries nor joint ventures. A simplistic but logical view would be if percentage ownership was considered. A range of 20%-50% ownership would indicate that the investing company has influence over the business in which it has invested – over the associate. With this range of ownership the investing business would be expected to have some rights with respect to the management, dividend payment and the use of assets of the associate. The underlying concept is that the share of worth or net assets, and results of this substantially owned (but not controlled or jointly managed) entity, should be brought into the investing businesses or group accounts. The alternative (required for ownership below the 20% threshold or where influence is restricted) is only to recognise dividends from the owned entity – a prudent approach.

Associate versus joint venture

The difference between say a 33.33% holding in an associate and a similar percentage investment in a joint venture is that a joint venture has an agreement where the influence is joint and control is jointly agreed with other parties. In an associate the holding may give 'significant influence' but no joint control. In a joint venture each venturer has the power of veto over key decisions.

E Key Content of the Standard

Objective

This 'old' IAS did not have an objective.

Definitions

An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The equity method is a method of accounting whereby the investment is initially recognised 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.

Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

Required Practice

Significant influence

6 If an investor holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (e.g. through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

7 The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

a) representation on the board of directors or equivalent governing body of the investee;

b) participation in policy-making processes, including participation in decisions about dividends or other distributions;

c) material transactions between the investor and the investee;

d) interchange of managerial personnel; or

e) provision of essential technical information.

Equity method

APPLICATION OF THE EQUITY METHOD

13 An investment in an associate shall be accounted for using the equity method except when:

a) the investment is classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations;

b) the exception in paragraph 10 of IAS 27, allowing a parent that also has an investment in an associate not to present consolidated financial statements, applies; or

c) all of the following apply:

i) the investor is a wholly-owned subsidiary, or 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;

ii) the investor's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

iii) the investor did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market; and

iv) the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

DISCLOSURE 37–40

There is a comprehensive list of possible disclosures.

F Significant differences in GAAP

US GAAP

US and IFRS practice is now generally similar for accounting for non-controlling interests (which includes associates). The US FAS 160 is titled Non-controlling interests in consolidated financial statements.

UK GAAP

Whilst definitions of associates are similar the UK FRS 9 definition is more restrictive in that it requires the investor to actually exercise significant influence if the investment is to be accounted for as an associate. Thus under IAS 28 more investments may be accounted for as associates than under FRS 9.

30
Financial reporting of interests in joint ventures – IAS 31

A Key points

- For good commercial reasons some investments are shared and there is joint control.
- No single entity controls and thus cannot consolidate.
- The investors control – and jointly so.
- The standard sets out how to account for the share of joint ventures, assets, liabilities and results.

B What does the IAS contain?

C Why needed

Businesses frequently enter into agreements with other businesses to share resources, expertise etc. with a view to achieving jointly that which would be difficult or impossible to achieve on their own – they enter into joint ventures.

The joint venture activities may be undertaken and accounted for in different ways. The issues are what details of the jointly owned assets, liabilities, income and expenses should be disclosed.

The objective of this Standard is to reflect the effect on an investor's financial position and performance of its interests in a joint venture, for whose activities it is partly accountable, because of the closeness of its involvement, as a result of its long-term interest and joint control.

D Ideas – concepts

Joint ventures are classified into three types:

1 jointly controlled operations

2 jointly controlled assets (and liabilities)

3 jointly controlled entities

Jointly controlled operations and assets are really similar. It is for convenience that businesses share operations and assets jointly. Two or more businesses carry on their own business, the only link being the common use of assets or operations. Accounting for them is obvious and straightforward. The investor records its share of assets, liabilities, income and expenses in its own financial statements.

The jointly controlled entity operates as a business in its own right. A jointly controlled entity could be a partnership or some other legal structure; commonly limited companies are used. The recommended benchmark treatment is to proportionally consolidate the share of assets, liabilities, income and expenses of the joint venture business as at the balance sheet date. The rationale for this is that 'joint control' is just that. The investor has full rights of access and control over its proportion of net assets and income, and thus all relevant figures should be consolidated along with those of other group joint ventures and subsidiaries.

Joint venture versus associate

The difference between say a 33.33% holding in a joint venture and an investment in an associate is that the joint venture holding has an agreement where the influence is joint and control is jointly agreed with other parties. In an associate the holding may give 'significant influence' but no joint control – the majority shareholder has power of veto.

E Key Content of the Standard

Objective

This 'old' IAS did not have an objective.

Definitions

Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

The equity method is a method of accounting whereby an interest in a jointly controlled entity is initially recorded at cost and adjusted thereafter for the post-acquisition change in the venturer's share of net assets of the jointly controlled entity. The profit or loss of the venturer includes the venturer's share of the profit or loss of the jointly controlled entity.

An investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Proportionate consolidation is a method of accounting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is combined line by line with similar items in the venturer's financial statements or reported as separate line items in the venturer's financial statements.

Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

Significant influence is the power to participate in the financial and operating policy decisions of an economic activity but is not control or joint control over those policies.

A venturer is a party to a joint venture and has joint control over that joint venture.

Required Practice

Forms of joint venture

Joint ventures take many different forms and structures. This Standard identifies three broad types – jointly controlled operations, jointly controlled assets and jointly controlled entities – that are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

a) two or more venturers are bound by a contractual arrangement; and

b) the contractual arrangement establishes joint control.

Contractual arrangement

9 The existence of a contractual arrangement distinguishes interests that involve joint control from investments in associates in which the investor has significant influence (see IAS 28). Activities that have no contractual arrangement to establish joint control are not joint ventures for the purposes of this Standard.

JOINTLY CONTROLLED OPERATIONS

15 In respect of its interests in jointly controlled operations, a venturer shall recognise in its financial statements:

a) the assets that it controls and the liabilities that it incurs; and

b) the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture.

JOINTLY CONTROLLED ASSETS

21 In respect of its interest in jointly controlled assets, a venturer shall recognise in its financial statements:

a) its share of the jointly controlled assets, classified according to the nature of the assets;

b) any liabilities that it has incurred;

c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

e) any expenses that it has incurred in respect of its interest in the joint venture.

Proportionate consolidation

30 A venturer shall recognise its interest in a jointly controlled entity using proportionate consolidation or the alternative method described in paragraph 38. When proportionate consolidation is used, one of the two reporting formats identified below shall be used.

Equity method

38 As an alternative to proportionate consolidation described in paragraph 30, a venturer shall recognise its interest in a jointly controlled entity using the equity method.

DISCLOSURE

56 A venturer shall disclose a listing and description of interests in significant joint ventures and the proportion of ownership interest held in jointly controlled entities.

57 A venturer shall disclose the method it uses to recognise its interests in jointly controlled entities.

F Significant differences in GAAP

US GAAP

US GAAP defines a joint venture only as a corporate joint venture.

Generally jointly controlled entities are accounted for using the equity method. Proportionate consolidation is allowed only in certain industries for unincorporated ventures.

UK GAAP

Under FRS 9 only jointly controlled entities are classified as joint ventures whereas IAS 31 identifies three types of joint venture:

- jointly controlled operations
- jointly controlled assets
- jointly controlled entities

31
Operating segments – IFRS 8

Effective for periods commencing after 1 January 2009

A Key points

- Users of its financial statements have to evaluate business activities.
- Financial statements do not have the detailed analysis that management accounts do.
- This standard requires disclosure of the data that executives have used to manage the business.

B What does the IAS contain?

- Reconciliations 8
- Restatement of previously reported information 29–30
- ENTITY-WIDE DISCLOSURES 31–34
- Information about products and services 32
- Information about geographical areas 33
- Information about major customers 34

D Why needed

Key uses of financial statements include:

- to identify performance – returns on investment and margins; and
- to know the amount and existence of assets and liabilities – where capital is employed in the business.

In accounts with diverse business activities and operating in different countries, summary figures present the overall picture and no detailed analysis is possible. A detailed breakdown of the figures is required. Note: It does seem questionable that an Accounting Standard should be needed for such a topic. Certainly for listed companies it might be assumed that the markets and analysts' pressures would demand full disclosure – analysts would demand even more detailed data than is publicly available. This may not be the case though, as UK, US and IAS have had Standards in place for some time. This may indicate that some companies are reluctant to voluntarily disclose information.

E Ideas – concepts

Where financial statements are an amalgam of various activities in different locations, the overall results and net assets are disclosed when the financial statements are consolidated. However, performance of the various activities and of various locations may be impossible to ascertain. The aim of this

Standard is simple: to break down and present an analysis of the business as it would be for executive management purposes.

Objective – core principle

1 An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Definitions

Operating segment. An operating segment is a component of an entity:

a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),

b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

c) for which discrete financial information is available.

Required Practice

OPERATING SEGMENTS

5 An operating segment is a component of an entity:

a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),

b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

c) for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

7 The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.

REPORTABLE SEGMENTS

11 An entity shall report separately information about each operating segment that:

a) has been identified in accordance with paragraphs 5–10 or results from aggregating two or more of those segments in accordance with paragraph 12, and

b) exceeds the quantitative thresholds in paragraph 13.

DISCLOSURE

20 An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

MEASUREMENT

25 The amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance.

Reconciliations 28

One criticism at the time of introducing the IFRS was that it was impracticable because "management accounts may not reconcile to the financials" – a grave worry if this were the case! Paragraph 28 rightly requires reconciliations.

F Significant differences in GAAP

US GAAP

The IFRS is based on US practice.

UK GAAP

There is no similar UK standard – just an out of date SSAP no 25.

32
Financial instruments – disclosure and presentation – IAS 32

A Key points

- The first standard on the topic of 'Financial Instruments'.
- Requiring disclosure and proper presentation was a shock for many!
- It now only covers presentation of financial instruments.

B What does the IAS contain?

C Why needed

Users of financial statements need to know what is going on in a business. Financial instruments, particularly complex and speculative ones can have huge effects on the worth and results of a business. There needs to be consistency of presentation, that is where figures and narrative are to be found in financial statements.

D Ideas – concepts

One obvious way of helping users is to insist on proper and full disclosure and presentation of all financial instruments. IAS 32 was the first standard on financial instruments and less controversial than IAS 39 as it is only about proper presentation – disclosure is now covered by IFRS 7.

E Key Content of the Standard

Objective

1 [Deleted]

2 The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

3 The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in IAS 39 Financial Instruments: Recognition and Measurement, and for disclosing information about them in IFRS 7 Financial Instruments: Disclosures.

Definitions

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is:

a) cash;

b) an equity instrument of another entity;

c) a contractual right:

   i) to receive cash or another financial asset from another entity; or

   ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

d) a contract that will or may be settled in the entity's own equity instruments and is:

   i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

   ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

A financial liability is any liability that is:

a) a contractual obligation:

   i) to deliver cash or another financial asset to another entity; or

   ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

b) a contract that will or may be settled in the entity's own equity instruments and is:

   i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

   ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not

include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

12 The following terms are defined in paragraph 9 of IAS 39 and are used in this Standard with the meaning specified in IAS 39.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract

- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

Required Practice

PRESENTATION

Much of IAS 32 is concerned about identifying and distinguishing between financial liabilities and equity. Paragraphs 15 to 32 set out requirements and give guidance.

Disclosure

51–95 [Deleted] – moved to IFRS 7 – Financial Instruments: disclosures.

F Significant differences in GAAP

US GAAP

Under US GAAP there are presentation requirements for SEC registrants.

UK GAAP

UK FRS 25 with the same name is converged.

33
Financial Instruments: recognition and measurement – IAS 39

See later in this chapter – this contentious Standard is being improved.

A Key points

- The term 'financial instruments' encompasses more than loans.
- Financial instruments – assets and liabilities should be recognised on balance sheets.
- Requiring recognition and measurement of 'financial instruments' was and is a real shock for many!
- Putting a value on financial instruments can be difficult.

B What does the IAS contain?

C Why needed

A business may have borrowings and loans – clear liabilities, but can also have entered into and committed itself to further huge liabilities by dint of entering into options and other contracts – with the hope of gaining, or at least managing, the potential for losses – BUT where are the assets to support gains? AND what is the extent of the possible liabilities?

This Standard is the follow on to IAS 32, Financial Instruments: Disclosure and Presentation, and aims to quantify, or at least reveal in monetary terms, the effect of owning financial assets and being committed to financial liabilities. This remains a controversial Standard and further revisions are due to be issued in due course.

D Ideas – concepts

Valuation of financial assets and liabilities

Financial assets (investments and loans) are unlikely to hold a constant value over time. The very word 'investment' implies that there is an expectation of income or profit. This income or profit may be paid over periodically or subsumed in the original investment, and thus increase its value. Financial assets may also lose value. The concept of writing down assets to their realisable amount is well established – the prudence concept. However, there are many possible bases for valuing assets that appreciate in value. The most prudent is to leave them at original cost, thus understating balance sheet value. As outlined in the introduction a driving principal of the Standards is to make the balance sheet more of a valuation statement. This Standard thus requires financial assets to be shown at fair value in the balance sheet and any resultant profit or loss on revaluation shown in the income statement or against equity, where appropriate.

Hedging

Hedging means having matched assets and liabilities where the change in the value of one will be covered or off-set by a compensating change in the other's value. A common use of hedging is where investments are made in one currency and the financing is obtained in the same currency, or a currency that is linked to the currency of the investment – if the value of the investment falls, then the amount of financing to be repaid falls by an equal amount. However, businesses may also speculate on currency movements. There may be an unrelated compensating asset or liability, but there is no true hedge in this case. The Standard aims to allow hedge accounting only where hedging genuinely exists.

Derivatives

A derivative is a financial instrument or other contract with all three of the following characteristics:

a) its value changes in response to the change the value of a specified item (e.g. interest rate, financial instrument price, commodity price etc). This is sometimes called the 'underlying';

b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

c) it is settled at a future date

No doubt some derivatives and their trading can be beneficial to business – you are buying 'insurance', fixing a price of a commodity in volatile markets – you may gain or lose a bit but you have fixed the price.

The question is how much derivative purchasing and trading is for such purposes? If it is done to speculate – that is gambling. When the speculation is done with others' money that is very lucky! It is good to have banker friends who will lend for your gambling!!

Objective

1 The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in IAS 32 Financial Instruments: Presentation. Requirements for disclosing information about financial instruments are in IFRS 7 Financial Instruments: Disclosures.

Definitions

Financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if:

   i) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

   ii) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

   iii) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the

positive intention and ability to hold to maturity (see Appendix A paragraphs AG16–AG25) other than:

a) those that the entity upon initial recognition designates as at fair value through profit or loss;

b) those that the entity designates as available for sale; and

c) those that meet the definition of loans and receivables.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:

a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;

b) those that the entity upon initial recognition designates as available for sale; or

c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale. An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as:

a) loans and receivables,

b) held-to-maturity investments or

c) financial assets at fair value through profit or loss.

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) Definition of a financial guarantee contract Definitions relating to recognition and measurement but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 **Revenue**), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A forecast transaction is an uncommitted but anticipated future transaction.

A hedging instrument is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 72–77 and Appendix A paragraphs AG94–AG97 elaborate on the definition of a hedging instrument).

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that:

a) exposes the entity to risk of changes in fair value or future cash flows and

b) is designated as being hedged (paragraphs 78–84 and Appendix A paragraphs AG98–AG101 elaborate on the definition of hedged items).

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105–AG113).

Required Practice

The order of the Standard may not, at first sight, appear logical. It starts with a requirement to identify embedded derivatives – financial instruments contained within another instrument. Once this is done then logically the Standard covers recognition and derecognition, measurement and then the special topic of hedging.

EMBEDDED DERIVATIVES

11 An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:

a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG33);

b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

Many contracts such as leases, contracts for the sale or purchase of goods, and construction contracts may include terms that designate at least part of the transaction a derivative – payments/receipts based on variables such as interest rates, currency rates or commodity prices.

RECOGNITION AND DERECOGNITION

Initial recognition

14 An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the

instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)

Derecognition of a financial asset

16 Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17–23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

17 An entity shall derecognise a financial asset when, and only when:

a) the contractual rights to the cash flows from the financial asset expire; or

b) it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20. (See paragraph 38 for regular way sales of financial assets.)

18 An entity transfers a financial asset if, and only if, it either:

a) transfers the contractual rights to receive the cash flows of the financial asset; or

b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.

Transfers that qualify for derecognition

There follow pages of detailed required practice in respect of the many different types of financial assets and methods of sale that arise in practice.

Regular way purchase or sale of a financial asset

38 A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see Appendix A paragraphs AG53–AG56)

Derecognition of a financial liability

39 An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished – i.e. when the obligation specified in the contract is discharged or cancelled or expires.

As for financial assets there follow paragraphs of detailed required practice in respect of the many different types of financial liabilities and methods of settlement that arise in practice.

MEASUREMENT

Initial measurement of financial assets and financial liabilities 43–44

43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Subsequent measurement of financial assets 45–46

46 After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

a) loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;

b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and

c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

Subsequent measurement of financial liabilities

47 After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:

a) financial liabilities at fair value through profit or loss.

b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies.

c) financial guarantee contracts as defined in paragraph 9.

d) commitments to provide a loan at a below-market interest rate.

Fair value measurement considerations

48 In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, IAS 32 or IFRS 7, an entity shall apply paragraphs AG69–AG82 of Appendix A.

48A The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique.

The IASB (and FASB) have issued and no doubt will continue to produce further guidance on the topic of fair value measurement.

Hedge accounting

86 Hedging relationships are of three types:

a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

b) cash flow hedge: a hedge of the exposure to variability in cash flows that

i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and

ii) could affect profit or loss.

c) hedge of a net investment in a foreign operation as defined in IAS 21.

88 A hedging relationship qualifies for hedge accounting under paragraphs 89–102 if, and only if, all of the following conditions are met.

a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105–AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

d) The effectiveness of the hedge can be reliably measured.

e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Paragraphs 89-94 then set out detailed requirements for the three types of hedge.

F Significant differences in GAAP

US GAAP

Under US GAAP there are particular presentation requirements for SEC registrants.

UK GAAP

UK FRS 26 with the same name is converged.

G The future IFRS 9 Financial Instruments

The objective of the project is to improve the decision-usefulness (that wonderful term!) of financial statements for users by simplifying the classification and measurement requirements for financial instruments. The project will ultimately replace IAS 39 Financial Instruments: Recognition and Measurement.

The IASB's plan for the replacement of IAS 39 consists of three main phases:

Phase 1: Classification and measurement. On 12 November 2009, the IASB published IFRS 9 Financial Instruments on the classification and measurement of financial assets. The Board has finalised this phase in time to allow, but not require, early application for 2009 year end financial statements.

The IASB is continuing to deliberate the classification and measurement of financial liabilities. The IASB plans to issue an exposure draft on this part of the project when the FASB issues its comprehensive ED on accounting for financial instruments (covering classification and measurement, impairment and hedge accounting for hedged financial instruments). The target date for the FASB's exposure draft is the first quarter of 2010.

The biggest improvement so far is that the convoluted four types of financial assets have been reduced to two with fairly clear definitions:

Classification

An entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:

a) the entity's business model for managing the financial assets; and

b) the contractual cash flow characteristics of the financial asset.

A financial asset shall be measured at amortised cost if both of the following conditions are met:

i) the objective of the entity's business model is to hold the financial asset in order to collect the contractual cash flows; and

ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

Phase 2: Impairment methodology. On 5 November 2009, the IASB published for public comment the exposure draft Financial Instruments: Amortised Cost and Impairment. The ED is open for comment until 30 June 2010.

Phase 3: Hedge accounting. The Board is currently conducting outreach with its constituents and intends to issue an exposure draft on hedge accounting in the first quarter of 2010.

Removing inconsistencies between US GAAP and IFRS in accounting for financial instruments would enable comparisons to be made more easily between entities applying IFRSs and those using US GAAP.

34
Financial Instruments: disclosures – IFRS 7

A Key points

- Full disclosure of the types of financial instruments and their contractual terms is essential in investors and analysts are to understand the financial risks that an entity may face.
- This Standard requires a LOT of disclosure.

B What does the IAS contain?

C Why needed

What is debt (loans) and what is equity (risk capital)? It should be obvious, but with today's fashion, pressure and genuine need for diverse financial instruments it may be that the distinction is not clear. This Standard aims to define what is not equity.

A business may have borrowings and loans – definite liabilities, but can also have entered into and committed itself to further liabilities by dint of acquiring options and other contracts. The aim (or hope might be a

better word) is to make gains or at least balance gains and losses. The issue is to reveal the extent of these, often 'off balance sheet' liabilities. Also are there corresponding assets to support the liabilities?

D Ideas – concepts

The aim is to give information that can help identify the risks a business has in respect of financial instruments. The extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk.

Objective

1 The objective of this IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:

   a) the significance of financial instruments for the entity's financial position and performance; and

   b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

2 The principles in this IFRS complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement.

Definitions

Credit risk. The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Currency risk. The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Interest rate risk. The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Liquidity risk. The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

Loans payable. Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.

Market risk. The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

Other price risk. The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Past due. A financial asset is past due when a counterparty has failed to make a payment when contractually due.

Required Practice

There are only two emboldened (standard) practice paragraphs.

IFRS 7 applies to all risks arising from all financial instruments, except those instruments listed in paragraph 3 of the standards.

It is important to appreciate that the IFRS applies to all entities, including entities that have few financial instruments (e.g. a simple business whose only financial instruments are accounts receivable and accounts payable).

The standards include in Appendix B mandatory application guidance that explains how to apply the requirements of the standards.

There is also non-mandatory Implementation Guidance that suggests how an entity might provide the disclosures required by the standards.

Significance of financial instruments for financial position and performance

7 An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

The body of the standard, the guidance and implementation notes cover the classes of financial instruments as defined in IAS 39 and the specific disclosures required on derecognition or reclassification.

Accounting policies

21 In accordance with paragraph 117 of IAS 1 Presentation of Financial Statements (as revised in 2007), an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Nature and extent of risks arising from financial instruments

31 An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Qualitative disclosures

33 For each type of risk arising from financial instruments, an entity shall disclose:

a) the exposures to risk and how they arise;

b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

c) any changes in (a) or (b) from the previous period.

Quantitative disclosures

34 For each type of risk arising from financial instruments, an entity shall disclose:

a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity.

b) the disclosures required by paragraphs 36–42, to the extent not provided in (a), unless the risk is not material

c) concentrations of risk if not apparent from (a) and (b).

35 If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

The body of the Standard, the guidance and implementation notes set out what ought to be disclosed in respect of credit risk, liquidity risk and market risk and the Standard includes in Appendix B mandatory application guidance that explains how to apply the requirements of the standards.

There is also non-mandatory Implementation Guidance that suggests how an entity might provide the disclosures required by the Standards.

F Significant differences in GAAP

US GAAP

Under US GAAP there are presentation requirements when an entity falls under SEC regulation.

UK GAAP

UK FRS with the same name is converged.

35
Accounting and reporting by retirement benefit plans – IAS 26

A Key points

- Are there sufficient funds to cover pension liabilities?
- Is measurement of the assets and liabilities prudent and consistent?
- This standard aims to answer these questions and is the mirror of IAS 19.

B What does the IAS contain?

C Why needed

Investors, but maybe more so employees (prospective pensioners), and existing pensioners need to know whether a business's pension scheme is adequately funded. Retirement benefit plans or pension schemes are for the benefit of employees past and present. The accounts of such funds should clearly and fairly state the basis on which assets and liabilities are recognised and valued in the scheme's balance sheet.

D Ideas – concepts

Balance sheets of investment funds – for retirement benefits or pensions, could be drawn up on many different bases. What is needed is an up to date value of the investment assets along with a calculation of future liabilities (expressed in today's terms). If these are in balance the scheme is adequately funded. If the present value of future liabilities is in excess of the fair value of the schemes assets then the scheme is under funded.

Definitions

Retirement benefit plans are arrangements whereby an entity provides benefits for employees on or after termination of service (either in the form of an annual income or as a lump sum) when such benefits, or the contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service.

Funding is the transfer of assets to an entity (the **fund**) separate from the employer's entity to meet future obligations for the payment of retirement benefits.

For the purposes of this Standard the following terms are also used:

- **Participants** are the members of a retirement benefit plan and others who are entitled to benefits under the plan.
- **Net assets available for benefits** are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.
- **Actuarial present value of promised retirement benefits** is the present value of the expected payments by a retirement benefit plan to existing and past employees, attributable to the service already rendered.
- **Vested benefits** are benefits, the rights to which, under the conditions of a retirement benefit plan, are not conditional on continued employment.

Required Practice

Defined contribution plans 13 – 16

13 The financial statements of a defined contribution plan shall contain a statement of net assets available for benefits and a description of the funding policy.

14 Under a defined contribution plan, the amount of a participant's future benefits is determined by the contributions paid by the employer, the participant, or both, and the operating efficiency and investment earnings of the fund. An employer's obligation is usually discharged by contributions to the fund. An actuary's advice is not normally required although such advice is sometimes used to estimate future benefits that may be achievable based on present contributions and varying levels of future contributions and investment earnings.

Defined benefit plans

17 The financial statements of a defined benefit plan shall contain either:

a) a statement that shows:

i) the net assets available for benefits;

ii) the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; and

iii) the resulting excess or deficit; or

b) a statement of net assets available for benefits including either:

i) a note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; or

ii) a reference to this information in an accompanying actuarial report.

If an actuarial valuation has not been prepared at the date of the financial statements, the most recent valuation shall be used as a base and the date of the valuation disclosed.

18 For the purposes of paragraph 17, the actuarial present value of promised retirement benefits shall be based on the benefits promised under the terms of the plan on service rendered to date using either current salary levels or projected salary levels with disclosure of the basis used. The effect of any changes in actuarial assumptions that have had a significant effect on the actuarial present value of promised retirement benefits shall also be disclosed.

19 The financial statements shall explain the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits, and the policy for the funding of promised benefits.

20 Under a defined benefit plan, the payment of promised retirement benefits depends on the financial position of the plan and the ability of contributors to make future contributions to the plan as well as the investment performance and operating efficiency of the plan.

21 A defined benefit plan needs the periodic advice of an actuary to assess the financial condition of the plan, review the assumptions and recommend future contribution levels.

An accurate and reliable actuarial valuation is at the core of proper measurement of pension liabilities and thus the surplus or deficit of funds.

Valuation of plan assets

32 Retirement benefit plan investments shall be carried at fair value. In the case of marketable securities fair value is market value. Where plan investments are held for which an estimate of fair value is not possible disclosure shall be made of the reason why fair value is not used.

Disclosure

34 The financial statements of a retirement benefit plan, whether defined benefit or defined contribution, shall also contain the following information:

a) a statement of changes in net assets available for benefits;

b) a summary of significant accounting policies; and

c) a description of the plan and the effect of any changes in the plan during the period.

There follows an extensive list of further disclosures. In the UK and other jurisdictions there may be yet more disclosure required as pensions can be an emotive if not political issue.

F Significant differences in GAAP

US GAAP

There is no comparable standard.

UK GAAP

There is no comparable standard. The Pensions Regulator has an interest in the proper reporting of and the adequacy of UK pension funds.

36
Insurance contracts – IFRS 4

A Key points

- This (interim) standard:
  - requires improvement in accounting policies to ensure they align with the IASB Framework;
  - requires the carrying out of liability adequacy tests;
  - requires disclosure about the amount, timing and uncertainty of future cash flows.

B What does the IAS contain?

C Why needed

Accounting practices for insurance contracts have been diverse, and have often differed from practices in other sectors. This Standard is a first phase aimed at improving accounting for insurance and requiring disclosure of information about such contracts. The adoption of IFRS by many entities and increased scrutiny and regulation of the insurance sector are other drivers for IFRS's for this specialised sector.

The IFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSs. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS39 Financial Instruments: Recognition and Measurement. Nor does it address accounting by policyholders.

D Ideas – concepts

Insurance contracts are not like buying and selling goods in a supermarket. There the transaction (the contract) is usually concluded in a very short timescale with definite amounts of income, costs and profit. Insurance contracts can extend over years, the extent of liability (cost) may be virtually nil or large. The crystallisation of the liability (and cost) will depend on future events which may or may not happen. Furthermore, as there is an extended life to an insurance contract, sums need to be invested to cover future liabilities – the return on the investments (assets) will also depend on future events – prevailing interest rates, market conditions etc.

Thus there is much subjectivity behind many of the income, expense, asset and liability figures in the financial statements. There are many possible methods of accounting for assets/liabilities and profits/losses. There may be logic in netting off figures – e.g. were an insured amount is also reinsured by another entity.

The approach of this initial standard covering the insurance contracts is to align accounting with that set out in the IFRS framework, prohibit what is unacceptable practice and move accounting policies and disclosure towards what is considered best practice.

It is accepted that apart from treatment and disclosure which positively goes against the Framework and IAS 8 Accounting Policies, Changes in Accounting estimates and Errors, existing accounting policies may continue.

The three principal aims of the standards are to:

- Improve accounting policies and ensure they align with the Framework.
- Carry out liability adequacy tests and if there is a shortfall the entire amount should be recognised as a charge in profit and loss.
- Require disclosure about the amount, timing and uncertainty of future cash flows.

Objective

1 The objective of this IFRS is to specify the financial reporting for insurance contracts by any entity that issues such contracts (described in this IFRS as an insurer) until the Board completes the second phase of its project on insurance contracts. In particular, this IFRS requires:

a) limited improvements to accounting by insurers for insurance contracts.

b) disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Definitions

Cedant. The policyholder under a reinsurance contract.

Deposit component. A contractual component that is not accounted for as a derivative under IAS 39 and would be within the scope of IAS 39 if it were a separate instrument.

Direct insurance contract. An insurance contract that is not a reinsurance contract.

Discretionary participation feature. A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:

a) that are likely to be a significant portion of the total contractual benefits;

b) whose amount or timing is contractually at the discretion of the issuer; and

c) that are contractually based on:

i) the performance of a specified pool of contracts or a specified type of contract;

ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

iii) the profit or loss of the company, fund or other entity that issues the contract.

Fair value. The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial guarantee contract. A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Financial risk. The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

Guaranteed benefits. Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

Guaranteed element. An obligation to pay guaranteed benefits, included in a contract that contains a discretionary participation feature.

Insurance asset. An insurer's net contractual rights under an insurance contract.

Insurance contract. A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix B for guidance on this definition.)

Insurance liability. An insurer's net contractual obligations under an insurance contract.

Insurance risk. Risk, other than financial risk, transferred from the holder of a contract to the issuer.

Insured event. An uncertain future event that is covered by an insurance contract and creates insurance risk.

Insurer. The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.

Liability adequacy test. An assessment of whether the carrying amount of an insurance liability needs to be increased (or the carrying amount of related deferred acquisition costs or related intangible assets decreased), based on a review of future cash flows.

Policyholder. A party that has a right to compensation under an insurance contract if an insured event occurs.

Reinsurance assets. A cedant's net contractual rights under a reinsurance contract.

Reinsurance contract. An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.

Reinsurer. The party that has an obligation under a reinsurance contract to compensate a cedant if an insured event occurs.

Unbundle. Account for the components of a contract as if they were separate contracts.

Required Practice

Scope

2 An entity shall apply this IFRS to:

a) insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.

b) financial instruments that it issues with a discretionary participation feature (see paragraph 35). IFRS 7 Financial Instruments: Disclosures requires disclosure about financial instruments, including financial instruments that contain such features.

The standard does not apply to the likes of product warranties or where transactions are covered by another Standard, for example IAS 37 Provisions, Contingent Liabilities and Contingent Assets).

Recognition and measurement

Temporary exemption from some other IFRSs

13 Paragraphs 10–12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors specify criteria for an entity to use in developing an accounting policy if no IFRS applies specifically to an item. However, this IFRS exempts an insurer from applying those criteria to its accounting policies for:

a) insurance contracts that it issues (including related acquisition costs and related intangible assets, such as those described in paragraphs 31 and 32);

and

b) reinsurance contracts that it holds.

14 Nevertheless, this IFRS does not exempt an insurer from some implications of the criteria in paragraphs 10–12 of IAS 8.

Liability adequacy test

15 An insurer shall assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.

Ensuring that there is adequate cover for liabilities assumed under contract is at the core of this standard. The topics of liquidity and

capital adequacy generally are being considered by EU (European Union) and other regulators around the world.

16 If an insurer applies a liability adequacy test that meets specified minimum requirements, this IFRS imposes no further requirements. The minimum requirements are the following:

a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.

b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

Impairment of reinsurance assets

20 If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss.

A reinsurance asset is impaired if, and only if:

a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and

b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

Changes in accounting policies

21 Paragraphs 22–30 apply both to changes made by an insurer that already applies IFRSs and to changes made by an insurer adopting IFRSs for the first time.

22 An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to

those needs. An insurer shall judge relevance and reliability by the criteria in IAS 8.

23 To justify changing its accounting policies for insurance contracts, an insurer shall show that the change brings its financial statements closer to meeting the criteria in IAS 8, but the change need not achieve full compliance with those criteria.

Nature and extent of risks arising from insurance contracts

38 An insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.

F Significant differences in GAAP

US GAAP

US GAAP does have specific pronouncements on for the insurance sector. Definitions, the use of terms and practice may be quite different. This is undoubtedly an areas for future convergence.

UK GAAP

There is a UK standard but this covers Life assurance – FRS 27 – Life Assurance.

37
Exploration for and Evaluation of Mineral Resources – IFRS 6

A Key points

- There are differing views as to how exploration and evaluation expenditures should be accounted for.
- There is need for a single acceptable approach, consistent with the IFRS framework and other existing IFRS's.
- This standard is a first stage towards standard (and converged) practice.

B What does the IAS contain?

C Why needed

There are differing views as to how exploration and evaluation expenditures should be accounted for and the topic is excluded from IAS 16 Property, plant and equipment and IAS 38 Intangible assets. There are inconsistencies with analogous items, e.g. accounting for research and development costs covered by IAS 38. Other extant accounting standards have diverse approaches. Thus there is need for a single acceptable approach, consistent with the IFRS framework and other existing IFRS's, especially for entities adopting IFRS.

D Ideas – concepts

The basic issue is whether the often sizeable initial expenses for evaluating and exploring for mineral resources should be written off as incurred (being prudent), or capitalised as an asset which is then depreciated or amortised over the life of the project (accruals concept).

The obvious 'safe bet' would be to require all costs to be written off as incurred until such times as a viable extraction and cash generating project was initiated. However exploration and evaluation expenses can be large amounts and not matching the costs to the future revenue streams would seriously distort the financial reporting of entities undertaking large and continuing exploration and evaluation projects.

The Standard gives general guidance, permitting capitalisation of expenses associated with exploring and evaluating mineral resources. It permits existing accounting policies to be continued but does point to possibly improved disclosure. It specifically requires that any expenses capitalised as assets should be subject to impairment reviews and gives outline examples of signs of impairment.

Objective

1 The objective of this IFRS is to specify the financial reporting for the exploration for and evaluation of mineral resources.

2 In particular, the IFRS requires:

a) limited improvements to existing accounting practices for exploration and evaluation expenditures.

b) entities that recognise exploration and evaluation assets to assess such assets for impairment in accordance with this IFRS and measure any impairment in accordance with IAS 36 Impairment of Assets.

c) disclosures that identify and explain the amounts in the entity's financial statements arising from the exploration for and evaluation of mineral resources and help users of those financial statements understand the amount, timing and certainty of future cash flows from any exploration and evaluation assets recognised.

Definitions

Exploration and evaluation assets. Exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy.

Exploration and evaluation expenditures. Expenditure incurred by an entity in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

Exploration for and evaluation of mineral resources. The search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

Required Practice

Measurement at recognition

8 Exploration and evaluation assets shall be measured at cost.

Elements of cost of exploration and evaluation assets

9 An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources.

The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):

a) acquisition of rights to explore;

b) topographical, geological, geochemical and geophysical studies;

c) exploratory drilling;

d) trenching;

e) sampling; and

f) activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

10 Expenditures related to the development of mineral resources shall not be recognised as exploration and evaluation assets. The Framework and IAS 38 Intangible Assets provide guidance on the recognition of assets arising from development.

11 In accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources.

Measurement after recognition

12 After recognition, an entity shall apply either the cost model or the revaluation model to the exploration and evaluation assets. If the revaluation model is applied (either the model in IAS 16 Property, Plant and Equipment or the model in IAS 38) it shall be consistent with the classification of the assets (see paragraph 15).

Changes in accounting policies

13 An entity may change its accounting policies for exploration and evaluation expenditures if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An entity shall judge relevance and reliability using the criteria in IAS 8.

14 To justify changing its accounting policies for exploration and evaluation expenditures, an entity shall demonstrate that the change brings its financial statements closer to meeting the criteria in IAS 8, but the change need not achieve full compliance with those criteria.

Presentation

Classification of exploration and evaluation assets

15 An entity shall classify exploration and evaluation assets as tangible or intangible according to the nature of the assets acquired and apply the classification consistently.

16 Some exploration and evaluation assets are treated as intangible (e.g. drilling rights), whereas others are tangible (e.g. vehicles and drilling rigs). To the extent that a tangible asset is consumed

in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset. However, using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset.

Reclassification of exploration and evaluation assets

17 An exploration and evaluation asset shall no longer be classified as such when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Exploration and evaluation assets shall be assessed for impairment, and any impairment loss recognised, before reclassification.

Impairment

Recognition and measurement

18 Exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount. When facts and circumstances suggest that the carrying amount exceeds the recoverable amount, an entity shall measure, present and disclose any resulting impairment loss in accordance with IAS 36, except as provided by paragraph 21 below.

Operating Segments

22 The level identified by the entity for the purposes of testing exploration and evaluation assets for impairment may comprise one or more cash-generating units.

Disclosure

23 An entity shall disclose information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources.

24 To comply with paragraph 23, an entity shall disclose:

a) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.

b) the amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

25 An entity shall treat exploration and evaluation assets as a separate class of assets and make the disclosures required by either IAS 16 or IAS 38 consistent with how the assets are classified.

F Significant differences in GAAP

US GAAP

U.S. GAAP provides detailed guidance on accounting and reporting specifically for oil and gas (but not other extractive industries) producing entities for expenditure that occurs before, during and after exploration and evaluation.

UK GAAP

There is no specific UK GAAP on this topic.

38
Agriculture – IAS 41

A Key points

- What are agricultural or biologic assets?
- What value do you place on half grown crops?
- How do you value the 'finished' product?
- This standard aims to answer these questions.

B What does the IAS contain?

C Why needed

Agriculture is obviously a specialised area of business and thus accounting is specialised. Maybe this should be one of many Standards that cover specific industries.

D Ideas – concepts

What is the value of herds of beasts or crops? Many different values could be used. Unless growth is complete some crops are worthless, other crops or animals increase in value until they are ripe for harvesting or are fully mature.

To avoid selection of the most favourable (high or maybe low valuation) the Standard demands consistency in that agricultural produce is valued at fair value.

Objective

The objective of this Standard is to prescribe the accounting treatment and disclosures related to agricultural activity.

Definitions

Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

Agricultural produce is the harvested product of the entity's biological assets.

A biological asset is a living animal or plant.

Biological transformation comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.

Costs to sell are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.

A group of biological assets is an aggregation of similar living animals or plants.

Harvest is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

Recognition and measurement

10 An entity shall recognise a biological asset or agricultural produce when, and only when:

a) the entity controls the asset as a result of past events;

b) it is probable that future economic benefits associated with the asset will flow to the entity; and

c) the fair value or cost of the asset can be measured reliably.

11 In agricultural activity, control may be evidenced by, for example, legal ownership of cattle and the branding or otherwise marking of the cattle on acquisition, birth, or weaning. The future benefits are normally assessed by measuring the significant physical attributes.

12 A biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except for the case described in paragraph 30 where the fair value cannot be measured reliably.

13 Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying IAS 2 Inventories or another applicable Standard.

Gains and losses

26 A gain or loss arising on initial recognition of a biological asset at fair value less costs to sell and from a change in fair value less

costs to sell of a biological asset shall be included in profit or loss for the period in which it arises.

27 A loss may arise on initial recognition of a biological asset, because costs to sell are deducted in determining fair value less costs to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

28 A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in profit or loss for the period in which it arises.

29 A gain or loss may arise on initial recognition of agricultural produce as a result of harvesting.

Inability to measure fair value reliably

30 There is a presumption that fair value can be measured reliably for a biological asset. However, that presumption can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available and for which alternative estimates of fair value are determined to be clearly unreliable. In such a case, that biological asset shall be measured at its cost less any accumulated depreciation and any accumulated impairment losses. Once the fair value of such a biological asset becomes reliably measurable, an entity shall measure it at its fair value less costs to sell. Once a non-current biological asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale) in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations, it is presumed that fair value can be measured reliably.

Government grants

34 An unconditional government grant related to a biological asset measured at its fair value less costs to sell shall be recognised in profit or loss when, and only when, the government grant becomes receivable.

35 If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met.

Disclosure

General

40 An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.

41 An entity shall provide a description of each group of biological assets.

There then follows pages of disclosure. This Standard might be an example of just how detailed accounting and disclosure requirements might be if it is deemed that other specific business sectors require a Standard.

F Significant differences in GAAP

US GAAP and

Different terminology is used – "growing crops", "animals being developed for sale"' "harvested crops" and "animals held for sale" are used to describe what would be biological assets under IFRS.

Biological assets are stated at the lower of cost and market and agricultural produce is measured at sales price less costs of disposal when certain conditions are met.

UK GAAP

There is no UK GAAP on this topic.

39
Other financial reporting in hyper inflationary economies – IAS 29

A Key points

- Some economies can be subject to periods of hyper-inflation.
- How can business results be meaningfully measured and reported?

B What does the IAS contain?

C Why needed

Some economies can be subject to periods of hyper-inflation. The problem is how to meaningfully measure and report business results.

D Ideas – concepts

If prices have increased by a factor of say 100 times over a year then historic figures for balance sheet items such as plant and equipment, inventories will give a totally unrealistic picture of the economic value to the business of the assets. Also, reported net profit or loss based on historic costs will be totally distorted.

The figures for the period in question should be adjusted as at the year end balance sheet date, either by adjusting the historic cost figures with indices that adjust to the measuring unit (or currency), or by adjusting relevant balance sheet and earnings statement figures to current cost.

Scope

1 This Standard shall be applied to the financial statements, including the consolidated financial statements, of any entity whose functional currency is the currency of a hyperinflationary economy.

2 In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading.

The restatement of financial statements

8 The financial statements of an entity whose functional currency is the currency of a hyperinflationary economy, whether they are based on a historical cost approach or a current cost approach, shall be stated in terms of the measuring unit current at the end of the reporting period. The corresponding figures for the previous period required by IAS 1 Presentation of Financial Statements (as revised in 2007) and any information in respect of earlier periods shall also be stated in terms of the measuring unit current at the end of the reporting period. For the purpose of presenting comparative amounts in a different presentation currency, paragraphs 42(b) and 43 of IAS 21 The Effects of Changes in Foreign Exchange Rates apply.

9 The gain or loss on the net monetary position shall be included in profit or loss and separately disclosed.

Economies ceasing to be hyperinflationary

38 When an economy ceases to be hyperinflationary and an entity discontinues the preparation and presentation of financial statements prepared in accordance with this Standard, it shall treat the amounts expressed in the measuring unit current at the end of the previous reporting period as the basis for the carrying amounts in its subsequent financial statements.

Disclosures

39 The following disclosures shall be made:

a) the fact that the financial statements and the corresponding figures for previous periods have been restated for the changes in the general purchasing power of the functional currency and, as a result, are stated in terms of the measuring unit current at the end of the reporting period;

b) whether the financial statements are based on a historical cost approach or a current cost approach; and

c) the identity and level of the price index at the end of the reporting period and the movement in the index during the current and the previous reporting period.

F Significant differences in GAAP

US GAAP

There is no corresponding U.S. GAAP.

UK GAAP

FRS 24 – Financial reporting in hyper inflationary economies is fully converged.

40
Summary of IFRIC's

Introduction

Whilst the IASB aims to produce unambiguous standards there will be ambiguity and situations arising that were not envisaged at the time of drafting a Standard. The IFRS Interpretations Committee (IFRIC) exists to deal with and pronounce on any apparently material discrepancies in accounting or disclosure.

Below is a summary of extant IFRIC's – there also exist earlier SICs (Standard Interpretation Committee) pronouncements.

IFRIC Interpretation 1 – Changes in Existing Decommissioning, Restoration and Similar Liabilities

Many entities have obligations to dismantle, remove and restore items of property, plant and equipment. In this Interpretation such obligations are referred to as 'decommissioning, restoration and similar liabilities'. Under IAS 16, the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. IAS 37 contains requirements on how to measure decommissioning, restoration and similar liabilities.

This Interpretation provides guidance on how to account for the effect of changes in the measurement of existing decommissioning, restoration and similar liabilities.

IFRIC Interpretation 2 – Members' Shares in Co-operative Entities and Similar Instruments

Co-operatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a co-operative as a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in a co-operative are often characterised as members' shares, units or the like, and are referred to below as 'members' shares'. Some of the International Accounting Standards Board's constituents have asked for help in understanding how the principles in IAS 32 apply to members' shares and similar instruments that have certain features, and the circumstances in which those features affect the classification as liabilities or equity.

IFRIC Interpretation 4 – Determining whether an Arrangement contains a Lease

An entity may enter into an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset (e.g. an item of property, plant or equipment) in return for a payment or series of payments. Examples include:

- outsourcing arrangements (e.g. the outsourcing of the data processing functions of an entity).
- arrangements in the telecommunications industry, in which suppliers of network capacity enter into contracts to provide purchasers with rights to capacity.

- take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (e.g. a take-or-pay contract to acquire substantially all of the output of a supplier's power generator).

This Interpretation provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with IAS 17.

IFRIC Interpretation 5 – Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

The purpose of decommissioning, restoration and environmental rehabilitation funds, hereafter referred to as 'decommissioning funds' or 'funds', is to segregate assets to fund some or all of the costs of decommissioning plant (such as a nuclear plant) or certain equipment (such as cars), or in undertaking environmental rehabilitation (such as rectifying pollution of water or restoring mined land), together referred to as 'decommissioning'.

Contributions to these funds may be voluntary or required by regulation or law and involve one or more contributors. This IFRIC aims to answer the following points:

a) how should a contributor account for its interest in a fund?

b) when a contributor has an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor, how should that obligation be accounted for?

IFRIC Interpretation 6 – Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment

The Interpretation addresses neither new waste nor historical waste from sources other than private households. The liability for such waste management is adequately covered in IAS 37. However, if, in national legislation, new waste from private households is treated in a similar manner to historical waste from private households, the principles of the Interpretation apply by reference to the hierarchy in paragraphs 10–12 of IAS 8. The IAS 8 hierarchy is also relevant for other regulations that impose obligations in a way that is similar to the cost attribution model specified in the EU Directive.

IFRIC Interpretation 7 – Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies

This Interpretation provides guidance on how to apply the requirements of IAS 29 in a reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, when that economy was not hyperinflationary in the prior period, and the entity therefore restates its financial statements in accordance with IAS 29.

IFRIC Interpretation 8 – Scope of IFRS 2

IFRS 2 applies to share-based payment transactions in which the entity receives or acquires goods or services. 'Goods' includes inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets (IFRS 2, paragraph 5). Consequently, except for particular transactions excluded from its scope, IFRS 2 applies to all transactions in which the entity receives non-financial assets or services as consideration for the issue of equity instruments of the entity. IFRS 2

also applies to transactions in which the entity incurs liabilities, in respect of goods or services received, that are based on the price (or value) of the entity's shares or other equity instruments of the entity.

This Interpretation deals with whether IFRS 2 applies to transactions in which the entity cannot identify specifically some or all of the goods or services received.

IFRIC Interpretation 9 – Reassessment of Embedded Derivatives

IAS 39 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract.

This Interpretation deals with the following questions:

a) Does IAS 39 require such an assessment to be made only when the entity first becomes a party to the contract, or should the assessment be reconsidered throughout the life of the contract?

b) Should a first-time adopter make its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts IFRSs for the first time?

IFRIC Interpretation 10 – Interim Financial Reporting and Impairment

An entity is required to assess goodwill for impairment at the end of each reporting period, to assess investments in equity instruments and in financial assets carried at cost for impairment at the end of each reporting period and, if required, to recognise an impairment loss at that date in accordance with IAS 36 and IAS 39.

This Interpretation addresses the interaction between the requirements of IAS 34 and the recognition of impairment losses on goodwill in IAS 36 and certain financial assets in IAS 39, and the effect of that interaction on subsequent interim and annual financial statements.

IFRIC Interpretation 11 – IFRS 2 – Group and Treasury Share Transactions

Should the following transactions be accounted for as equity-settled or as cash-settled under the requirements of IFRS 2:

a) an entity grants to its employees rights to equity instruments of the entity (e.g. share options), and either chooses or is required to buy equity instruments (i.e. treasury shares) from another party, to satisfy its obligations to its employees; and

b) an entity's employees are granted rights to equity instruments of the entity (e.g. share options), either by the entity itself or by its shareholders, and the shareholders of the entity provide the equity instruments needed.

A second issue concerns the fact that for the purposes of the IFRS, transfers of an entity's equity instruments by its shareholders to parties that have supplied goods or services to the entity (including employees) are share-based payment transactions, unless the transfer is clearly for a purpose other than payment for goods or services supplied to the entity.

IFRIC Interpretation 12 – Service Concession Arrangements

In many countries, infrastructure for public services has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

This Interpretation deals with the following Issues

a) treatment of the operator's rights over the infrastructure;

b) recognition and measurement of arrangement consideration;

c) construction or upgrade services;

d) operation services;

e) borrowing costs;

f) subsequent accounting treatment of a financial asset and an intangible asset;

g) items provided to the operator by the grantor.

IFRIC Interpretation 13 – Customer Loyalty Programmes

Customer loyalty programmes are used by entities to provide customers with incentives to buy their goods or services. If a customer buys goods or services, the entity grants the customer award credits ('points'). The customer can redeem the award credits for awards – free or discounted goods or services.

The issue is whether the entity's obligation to provide free or discounted goods or services ('awards') in the future should be recognised and measured by:

i) allocating some of the consideration received or receivable from the sales transaction to the award credits and deferring the recognition of revenue (applying paragraph 13 of IAS 18); or

ii) providing for the estimated future costs of supplying the awards (applying paragraph 19 of IAS 18); and

and if (i) – consideration is allocated to the award credits:

iii) how much should be allocated to them;

iv) when revenue should be recognised; and

v) if a third party supplies the awards, how revenue should be measured.

The conclusion, to many of us, will at first sight fly in the face of conventional logic – that is to accrue for the incremental costs of delivering the 'free' good or services.

IFRIC Interpretation 14 – IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

Paragraph 58 of IAS 19 limits the measurement of a defined benefit asset to "the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan" plus unrecognised gains and losses. Questions have arisen about when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists.

IFRIC Interpretation 15 – Agreements for the Construction of Real Estate

In the real estate industry, entities that undertake the construction of real estate, directly or through subcontractors, may enter into agreements with one or more buyers before construction is complete. Such agreements take diverse forms.

a) Is the agreement within the scope of IAS 11 or IAS 18?

b) When should revenue from the construction of real estate be recognised?

IFRIC Interpretation 16 – Hedges of a Net Investment in a Foreign Operation

Many reporting entities have investments in foreign operations (as defined in IAS 21 paragraph 8). Such foreign operations may be subsidiaries,

associates, joint ventures or branches. IAS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in other comprehensive income until it disposes of the foreign operation.

This Interpretation provides guidance on where, within a group, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting. It also provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.

IFRIC Interpretation 17 – Distributions of Non-cash Assets to Owners

Sometimes an entity distributes assets other than cash (non-cash assets) as dividends to its owners acting in their capacity as owners. In those situations, an entity may also give its owners a choice of receiving either non-cash assets or a cash alternative. This Interpretation gives guidance on how an entity should account for such distributions.

The titles of earlier Standards Interpretation Committee announcements

SIC Interpretation 7 –	Introduction of the Euro
SIC Interpretation 10 –	Government Assistance – No Specific Relation to Operating Activities
SIC Interpretation 12 –	Consolidation – Special Purpose Entities
SIC Interpretation 13 –	Jointly Controlled Entities – Non-Monetary Contributions by Venturers

SIC Interpretation 15 – Operating Leases – Incentives

SIC Interpretation 21 – Income Taxes – Recovery of Revalued Non-Depreciable Assets

SIC Interpretation 25 – Income Taxes – Changes in the Tax Status of an Entity or its Shareholders

SIC Interpretation 27 – Evaluating the Substance of Transactions Involving the Legal Form of a Lease

SIC Interpretation 29 – Service Concession Arrangements: Disclosures

SIC Interpretation 31 – Revenue – Barter Transactions Involving Advertising Services

SIC Interpretation 32 – Intangible Assets – Web Site Costs

41
Basic financial statements and other issues

Section One: Financial statement components

A set of financial statements (or accounts) should contain the following:

- A balance sheet
- An income statement or profit and loss account (P&L Account)
- Accounting policies and explanatory notes
- A statement of cash flows
- A statement showing changes in equity

This section reviews:

- Balance sheets and profit and loss accounts, showing what they are made up of and what they intend to convey;
- The accounting framework, concepts and conventions; and
- Examples of cash flow statements – these are also covered in IAS 7 – Statements of Cash Flows.

The balance sheet

Balance sheets are laid out in many different formats. The order of items and format will almost inevitably be different for management purposes when compared to the published financial statements. In many jurisdictions

(e.g. the EU and UK) there will be legal (UK the 2006 Companies Act) requirements regarding the layouts.

A common layout and order of the assets and liabilities is simply to list assets from the top of the page followed by liabilities at the bottom.

From the perspective of management and those who wish to analyse the performance of an entity then the layout may be as follows: the balance sheet will be a statement showing net assets owned on one side and who owns and finances them on the other side, at a point in time.

Assets employed

Fixed assets – also known as non-current assets

+ Current assets
- Current liabilities
= **Net worth, Net book amount or Capital employed = X**

Financed by

Long term finance

+ Shareholders' Funds or Equity
= **Total Funding, Net worth or Capital employed = X**

This gives us what (in monetary terms) net assets or capital employed is used by the business and who finances that capital employed.

As far as possible it is desirable that period end balances show the up to date value to the business of the assets and the full extent of ownership and funding. BUT a balance sheet is not a valuation statement.

A very simple example:

The Income Statement or Profit & Loss Account

A profit and loss (P&L) account or income statement shows the sales, less costs/expenses for a period resulting in a profit or loss for the period.

Profit and Loss Account for the period ended….

Sales/turnover/revenue	700
–	
Cost of sales	**(500)**
=	
Gross profit	200
–	
Expenses/overheads	**(160)**

(grouped together either for management purposes or to meet statutory requirements)

=	
Net profit before tax	**(40)**

These two principal financial statements are meant to show correctly and fairly where a business is at the end of the period (the balance sheet), and whether it has made a profit or loss for the period (the P&L account).

Different statement layouts

A major problem for users of financial statements is the existence of different layouts. This just has to be accepted. Though some harmonisation has taken place, there is a long way to go till we get the definitive world-wide layout.

Published P&L or income statement layouts are likely to converge as more countries adopt IFRS and the relevant Standards are followed. However, it is unlikely that Accounting Standards can bring complete harmony to balance sheet layouts and readers of financial statements will have to cope with the different layouts – they can easily be rearranged to a familiar format.

Balance sheet layouts can be quite different, but the content is the same. Set out below are 3 examples of balance sheet layouts, all using the same figures.

- The first one is laid out for management purposes – clearly showing capital employed in the business on one side and capital invested on the other. This layout is essential if ratios such as return on investment (ROI) or return on capital employed (ROCE) are to be calculated (see section 2).
- The second one is laid out in the form that most UK companies publish.
- The third one is a listing of assets and liabilities (in reverse order to Europe) as typically found in US financial statements.

Here is an example of the German company Deutsche Telekom – showing the published figures (in a typical US format and order).

millions of €	Note	Dec. 31, 2008	Dec. 31, 2007*
Assets			
Current assets		**15,908**	**15,945**
Cash and cash equivalents	17	3,026	2,200
Trade and other receivables	18	7,393	7,696
Current recoverable income taxes	10	273	222
Other financial assets	24	2,169	2,019
Inventories	19	1,294	1,463
Non-current assets and disposal groups held for sale	20	434	1,103
Other assets		1,319	1,242
Non-current assets		**107,232**	**104,728**
Intangible assets	21	53,927	54,404
Property, plant and equipment	22	41,559	42,531
Investments accounted for using the equity method	23	3,557	118
Other financial assets	24	1,386	599
Deferred tax assets	10	6,234	6,610
Other assets		569	466
Total assets		**123,140**	**120,673**
Liabilities and shareholders' equity			
Current liabilities		**24,866**	**23,215**
Financial liabilities	25	10,208	9,075
Trade and other payables	26	7,073	6,823
Income tax liabilities	10	585	437
Other provisions	30	3,437	3,365
Liabilities directly associated with non-current assets and disposal groups held for sale	20	95	182
Other liabilities	28	3,468	3,333
Non-current liabilities		**55,162**	**52,213**
Financial liabilities	25	36,386	33,831
Provisions for pensions and other employee benefits	29	5,157	5,354
Other provisions	30	3,304	3,665
Deferred tax liabilities	10	7,108	6,675
Other liabilities	28	3,207	2,688
Liabilities		**80,028**	**75,428**
Shareholders' equity	31	**43,112**	**45,245**
Issued capital	32	11,165	11,165
Capital reserves	33	51,526	51,524
Retained earnings including carryforwards	34	(18,761)	(16,218)
Other comprehensive income	35	(5,411)	(4,907)
Net profit		1,483	571
Treasury shares	36	(5)	(5)
Equity attributable to equity holders of the parent		39,997	42,130
Minority interests	37	3,115	3,115
Total liabilities and shareholders' equity		**123,140**	**120,673**

* Prior-year figures adjusted. Accounting change in accordance with IFRIC 12. For explanations, please refer to "Summary of accounting policies/Change in accounting policies."

Below is the DT balance sheet summarised and re-grouped.

Balance Sheet summary	Deutsche Telekom Profile		- as % of capital em
Non-current assets			
Intangible	53,927		55%
Property plant and equipment	41,559		42%
Other	11,746		12%
		107,232	
Current assets	15,908		16%
Current liabilities	24,866		25%
Net current (liabilities)/assets		(8,958)	
Capital employed		**98,274**	
Non-current liabilities		55,162	56%
Shareholders' equity		43,112	44%
Total funding		**98,274**	

Accounting framework – the purpose of accounts

Book keeping with its rigorous arithmetic of pluses and minuses has and does serve well in providing an accounting framework. Business transactions are classified as assets or expenses (debtors/debits) and liabilities to owners or outsiders and income (creditors/credits). The majority of business transactions can be classified correctly.

However, there will be instances where differing views can be taken, e.g. is the purchase of a £2,000 personal computer an immediate expense of the business, to be charged as a debit in the P&L account, or is it and asset of the business to be shown as a fixed asset and capitalised in the balance sheet?

This illustrates the dilemma of whether expenses should be shown as such, or shown as assets. Even with this example most accountants would say there is no big issue. The computers should be capitalised, but then charged as an expense (depreciated) to the P&L account over say, 2

years. There will be valid differences of opinion on the period of charging depreciation (or writing off the asset) but as long as the time period is stated, users of the accounts can understand the figures presented.

Thus, book keeping with sensibly applied guidance on matters as above is a sound framework for producing financial statements. Or is it?

The academic, or rather economist leaning view, is that book keeping is far too simplistic. Assets and liabilities have to be defined in a more robust way.

Assets. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future, as a result of past transactions or events.

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

Expenses are decreases in economic benefits during an accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The IFRS's are all based on a framework which uses such definitions. In aiming to clarify exactly what the nature of an asset or liability is we have definitions that are at times unclear. One laudable aim of defining assets as they are defined is to make the balance sheet more of a 'valuation statement'. However, even here the Standard setters have had to back away or have been caught by their too clever definitions.

Fundamental accounting concepts

Traditionally there were four equally important fundamental concepts:

1. Going concern
2. Accruals or matching
3. Consistency
4. Prudence

On reflection the Standard setters now consider only the first two to be fundamental, consistency and prudence, being relegated to being 'desirable qualities'. This is interesting as one of; if not the prime aim of Accounting Standards is to bring consistency to reporting! That said, it is true that consistency is desirable but not fundamental – it may be appropriate to be inconsistent.

Being 'prudent' is a fundamental concept for those who intend to develop lasting businesses and thus makes sense when accounting for and reporting business transactions. However, the concept can be and has been abused. In good (or even bad!) times one might be too prudent, thus understating profits (or overstating losses!) to allow for 'smoothing' of future results.

The first two 'bedrock' concepts may be defined as follows:

Going concern

The preparer (and auditor) of the accounts should consider and check whether or not the enterprise is likely to continue in operational existence for the foreseeable future. This means in particular that there is no intention or necessity to liquidate or curtail significantly the scale of operations, and thus the P&L account and balance sheet will not be materially affected.

The 'going concern' concept also requires the preparer (and auditor) to consider and check that the business is likely to have cash/bank resources sufficient to remain in business for the foreseeable future – 'foreseeable future' is considered by Auditing Standards to be a period of at least twelve months beyond the date of signing the latest year end accounts.

Accruals or matching concept

Revenue and costs should be accrued (that is, recognised as they are earned or incurred, not as money is received or paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the P&L account of the period to which they relate.

The other two concepts may be defined as follows:

Consistency

There should be consistency of accounting treatment of like items within each accounting period and from one period to the next.

Prudence

Prudence means being cautious. Prudence is the inclusion of a degree of caution in the exercise of judgments needed in making the estimates required under conditions of uncertainty, such that assets or expenses are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow the creation of hidden reserves.

Qualitative characteristics of financial statements

There are many more words used by Standard setters in an attempt to make accounting fit into a clearly defined 'framework'. The following is a list of the terminology/definitions contained in the IASB Framework. At least one of the words is not recognised by spellcheckers! Maybe the Standard setters should acknowledge that accounting is an art and will never be a science!

Most of the words are used as they would be in normal everyday English. Comment is made on the terms that have special significance to accounts preparation.

- Understandability
- Relevance
- **Materiality**

The concept of materiality is well understood by accountants and auditors but may seem odd to those that believe accounting to be an exact science. What is material? It would be good to, and no doubt most accountants set out with the aim of producing 100% accurate accounts. However, take the example of the year end stock figure. It is carefully counted, damaged goods being identified and eliminated from the count. The stock-take figure totals 89,000, the stock records (adjusted for the damaged stock) show 92,000. What figures should be used? Is the 3,000 difference material? The answer – use the actual lower stock-take figure (this is prudent) and the difference is really not material. IF the difference was say 13,000, then both the stock-take process and the stock records would have to be reviewed.

- Reliability
- Faithful representation
- **Substance over form**

This is most important, and if followed rigorously Enron may not have happened! It means that it is the underlying business position that matters, not the legal form. For example, equipment may be leased over 5 years – 60 monthly instalments being paid; ownership of the equipment legally remains with the bank financing the equipment; BUT the substance of the transaction is that the equipment is 'owned', that is the economic benefits of ownership flow to the lessee. Equally the bank does not really consider it owns equipment – it has lent money to be repaid in 60 instalments.

- Neutrality
- Completeness
- Comparability

Constraints are acknowledged:

- timeliness;
- balance between benefit and cost;
- balance between qualitative characteristics; and
- true and fair view/fair presentation.

If there are profits there must be cash

If a business consistently generates profits from trading then there must be cash flowing into the business. However, this does not mean that the business will necessarily end up with a "cash mountain" – it depends on how cash generated is consumed or spent.

Cash could be spent on stocks or to fund debtors – cash could be tied up in working capital. Cash could be invested in tangible fixed assets or investments. Cash could be distributed to the owners as dividends.

It is seldom the case that the profit for a year equals the cash balance available at the end of the year. For businesses both large and small, it is generally considered wrong to have "cash mountains", either the cash should be invested in fixed assets and working capital to make the business grow, or returned to the owners for them to invest elsewhere.

Conversely, if a business makes a loss it does not necessarily follow that in the short-term there will be no cash. However, if a business continues to make losses over a number of years then unless there are injections of new funds into the business there will be an increasing cash deficit and ultimately the company will become insolvent.

Statements of Cash Flows (or cash flow statements)

For a proper understanding of a business it is vital to understand where cash came from and where it is being consumed. A reconciliation between opening and closing cash, bank and borrowing balances is needed. A cash flow statement aims to reveal such information.

Cash flow statements – a very simple illustration

The profit and loss account for a business for the year ended 31 March 201X shows that the business has made a profit of 3,000. It might be expected that as this is a very simple and straightforward business there will be a cash or bank balance of 3,000.

However, not all business transactions are for cash that is paid or received as cash immediately. In this illustration 6,000 of sales have been made to

a customer on credit, Similarly 1,500 of expenses do not have to be paid for until the next accounting year. The 2,000 charge for depreciation is a cost of consuming or using a van, but there is no cash payment in respect of this cost. The cash flows in respect of a van occur when it is purchased or finally disposed of.

Maybe more significantly, not all the cash transactions which a business undertakes relate to purchasing or selling goods or services, or paying for expenses – not all cash movements are related to P&L movements. Many cash transactions will be in respect of purchasing or selling assets, or incurring or settling liabilities – they will be related to movements or changes in balance sheet items.

In this simple illustration the business has also taken out a 9,000 loan during the year and spent 8,000 on the purchase of a van.

The net effect of the differences between occurrence of P&L transactions and the receipt or payment of cash, plus the other balance sheet movements in cash, is that in this simple illustration the business has a closing cash balance of 1,500 rather than 3,000 which is the profit figure. The principal reason is of course the 6,000 outstanding from customers.

Cash flow statements do not require additional record keeping, they may be produced by identifying the movements between the beginning and ending balance sheets, (adjusting for non-cash movements) – the indirect method and the one most commonly used in practice. They can also be prepared by appropriately summarising and classifying cash book entries – the direct method.

An illustration in the preparation of a cash flow statement is set out below.

Balance sheet as at 31 December 20X3

		20X3		20X2
Tangible fixed assets note 1		74,800		53,400
Current assets				
Stock	22,500		14,600	
Debtors	31,600		15,400	
Cash	2,200		1,300	
	56,300		31,300	
Current liabilities				
Overdraft	(13,900)		(1,900)	
Trade Creditors	(23,600)		(19,800)	
Taxation	(8,700)		(1,700)	
	(46,200)		(23,400)	
Net current assets		10,100		7,900
Total assets less current liabilities		84,900		61,300
Creditors: amounts falling due after more than one year				
Bank loan		(15,000)		(10,000)
		69,900		**51,300**
Called up share capital		20,000		20,000
Profit and loss account		49,900		31,300
		69,900		**51,300**

Note 1

	Land & buildings	Fixtures & fittings	Motor vehicles	Totals
Cost				
at 1.1.X3	51,100	5,500	0	56,600
Additions	0	16,000	9,200	25,200
at 31.12.X3	**51,100**	**21,500**	**9,200**	**81,800**
Accumulated depreciation				
at 1.1.X3	0	3,200	0	3,200
Charge for year	0	1,500	2,300	3,800
at 31.12.X3	**0**	**4,700**	**2,300**	**7,000**
Net book amount				
at 1.1.X3	51,100	2,300	0	53,400
at 31.12.X3	**51,000**	**16,800**	**6,900**	**74,800**

Note 2

For simplicity, the only profit is the operating profit for the year, being the movement on the profit and loss account.

Profit and loss account for the year ended

		20X3		20X2
Sales		210,000		198,000
Cost of sales		(105,100)		(102,400)
Gross profit		95,900		95,600
admin costs	(62,600)		(58,700)	
depreciation	(3,800)		(1,600)	
		(66,400)		(60,300)
Operating profit		29,500		35,300
Interest charge		(1,400)		(1,150)
Profit before tax		28,100		34,150
Taxation		(7,500)		(9,200)
Profit available for shareholders		20,600		24,950
Dividend paid		(2,000)		(18,000)
Profit retained		18,600		6,950
Profit brought forward		31,300		24,350
Profit carried forward		**49,900**		**31,300**

Inflows and outflows of funds

	Inflows	Outflows
Profit	29,500	
Depreciation	3,800	not a cash flow
Loans	5,000	
Stocks		7,900
Debtors		16,200
Creditors	3,800	
Taxation (paid)		500
Purchase of fixed assets		25,200
Interest paid		1,400
Dividend paid		2,000
	42,100	53,200
Net outflow	**-11,100**	
Change in cash and bank		
Decrease in cash	900	
Increase in overdraft	-12,000	
	-11,100	

Cash flow statement for the year ended 31 December 20X3

Cash flows from operating activities		
Cash generated from operations	**13,000**	**note 3**
Interest paid	(1,400)	
Tax paid	(500)	
Net cash from operating activities		**11,100**
Cash flows from/(to) investing activities		
Purchase of fixed assets		**(25,200)**
Cash flows from financing activities		
Increase in long term loan	5,000	
Dividends paid	(2,000)	
these could be shown under operating activities		
		3,000
Net (decrease)/increase in cash equivalents		**(11,100)**

Net (decrease)/increase in cash equivalents		
Opening cash	1,300	
Opening cash	2,200	
		900
Opening overdraft	1,900	
Closing overdraft	13,900	
		(12,000)
		(11,100)

Note 3: Cash generated by operating activities

Profit per accounts	29,500
Add back depreciation	3,800
Changes in working capital	
stock	(7,900)
debtors	(16,200)
creditors	3,800
Cash flow from operating activities	13,000

Section Two: Accounting ratios

This section reviews principal accounting ratios and comments, where appropriate, on how poor accounting may distort the ratios and where the Standards may affect the ratios.

Balance sheet ratios

Gearing ratios (leverage)

There are two commonly used ratios that tell us how much borrowing a company has, how highly 'Geared' or 'Leveraged' it is.

The gearing ratio

The gearing ratio = Long-term loans (or borrowings of whatever kind)

Shareholders' funds + long-term loans
= (capital employed or invested)

This is the more common definition of gearing for a company and levels might be considered as follows:

- **0%-20% – Low gearing**: It would be expected that most companies will have some borrowings and levels up to 20% are modest.
- **20%-35% – Medium gearing**: A normal level for many companies. Loans will be regularly taken out and repaid as the company invests in new assets or new business ventures. A company should be very clear as to why it has borrowings of, say, 31% – this level of gearing should not just happen!
- **35%-50% – High gearing**: This level of borrowing may be more applicable to some businesses than others, e.g. an investment property company would normally be highly geared due to the very significant investment in tangible fixed assets and more important still, the ability to repay loans from inflows from rental income. Gearing of this level requires careful management. When a company is 50%+ geared, the shareholders should ask, 'Whose company is it?' The company is certainly answerable (if not owned by) the banks.

Gearing may also be expressed by:

Debt to equity ratio = $\frac{\text{Long-term loans}}{\text{Shareholders' funds}}$

This is often the way banks express gearing. The numbers will be of a different order.

e.g. 50% gearing = 1 to 1 debt/equity ratio. The message conveyed by the ratio will be as for the gearing ratio.

Working capital ratios

A business has to meet its obligations as they fall due, or it may go bust! The business must have sufficient working capital. Working capital or liquidity ratios attempt to measure a company's ability to meet its short-term obligations as they fall due.

Current ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

The current ratio is calculated by dividing current assets by current liabilities. Current assets are cash and assets expected to be converted into cash within one year (e.g. WIP, stock and debtors); current liabilities are those that must be paid within one year (e.g. overdrafts, creditors and taxation). A business ought to be able to meet its current obligations if current assets exceed current liabilities. Textbooks traditionally quote this ratio as having to be 2:1 or better if a company was to be sound and able to pay its way. This might be true for a 'typical' business but many company's have ratios of less than 2:1 and are still able to meet their debts when they fall due. Much depends on the industry sector and size of business, e.g. a large supermarket chain might have only 12 days stock – this will be recorded at cost, but not pay its suppliers (of the stock) for 60 days, a super market could have negative working capital and a current ratio of less than 1:1.

Liquidity ratio/quick ratio/acid test ratio =
Current assets – stock or WIP
Current liabilities

Current assets include stock/WIP which is often not readily converted into cash. The liquidity ratio has stock/WIP taken out of the numerator. This provides a more rigorous test of the company's ability to settle its obligations as they fall due. Textbooks traditionally quote this ratio as having to be 1:1 or better, if a company is to survive! That is, its cash like assets (Debtors and Cash) must equal its current (immediately due) liabilities. There is a logic to this, but the ratio appropriate to a business will again very much depend on the type of business.

Performance measures

Ratio analysis

How do you measure the performance of a business?

The first measure that normally comes to mind is profitability – the business must make a profit.

Another measure – does the business generate positive cash flows, or at least sufficient cash to survive? This is important for all companies, but particularly listed companies as there is a need to pay regular cash dividends. Many analysts get too focused on one type of measure. For example, in the last few years there has been focus on ebitda (earnings before interest, tax, depreciation and amortisation). It is a measure of cash generation BUT there is still the underlying need to make profit – revenues must exceed expenses over the long-term!

Another measure of performance may be seen as efficient use of assets – how well does the business use its assets – do the managers 'make the assets sweat'.

There are also many non-financial measures of performance which may well have an effect on the level of financial performance. For example, staff turnover or the frequency of environmental law infringements.

The need to make an adequate return

The prime measure of a businesses success, or not, is the level of return on the capital employed (ROCE) or return on investment (ROI). It is a

ratio of the profit the business makes, divided by the capital employed needed to deliver the profit.

An example: 100,000 is invested in plant and machinery, stock, etc., and this can be used to manufacture and sell items, the profit at the end of a period, divided by the 100,000 will be the return on the capital invested or employed. This is similar to having 100,000 invested in a bank deposit account earning interest – say 9,800 over a period of a year, the return on capital invested or employed is:

$$\frac{9{,}800}{100{,}000} = 9.8\%$$

$$\text{Return on Capital Employed} = \frac{\text{Net Operating Profit}}{\text{Capital Employed}}$$

Net operating profit is normally taken as net operating profit of the ordinary on-going business before interest and taxation.

Capital employed is taken as the year end or average capital employed, in generating the profit.

It is obvious that return on capital employed could be calculated either before or after tax and interest. The figure which is used for calculation will depend very much on the reasons for looking at returns. For example, a shareholder interested in the return their company is giving may well only be concerned with profit after tax and interest. If it is performance measure that one is looking for, the profit before tax and interest is a clear indication of profit derived from using assets. Interest and taxation are related to other issues, the interest paid will depend on the financial structure of the company and the taxation dependent on the tax regime ruling at the time, or in the country concerned.

As most managers will be concerned with comparing their operating performance year by year they will not want this clouded by issues such as interest or tax payments.

In the following examples return on capital employed is considered to be:

$$\frac{\text{net operating profit (before interest and tax)}}{\text{capital employed}}$$

This gives a clearer and more consistent method of comparing companies – bench-marking.

As an illustration, we will take a company which has a return on capital employed of 20%. This is the prime ratio and this, the ratio analysis, splits up into two clear sub ratios and thus types of analysis.

$$\text{ROCE} = \frac{\text{net operating profit}}{\text{capital employed}} \qquad 20\%$$

$$\text{Net profit \%} = 10\% \quad \frac{\text{net op profit}}{\text{sales}} \times \frac{\text{sales}}{\text{capital employed}} \quad \frac{2}{1} = \text{Asset turnover}$$

The left hand ratio is called the net profit percent. The definition of net operating profit should be the same as that used for the calculation of return on capital employed and sales is the figure of net sales or turnover received in a year. The net profit % is the total sales less all labour, material, overhead costs. A net profit of 10% will be used as an example, although the rate of net profit will very much depend on the type of industry concerned.

The right hand ratio is called the asset turnover ratio or asset utilisation ratio. This is a ratio of:

- sales or turnover (as defined in net profit%)
- capital employed (as defined in return on capital employed)

This ratio is expressed as a multiple, 3:1, 5:1, 10:1, rather than 300%, 500% or 1,000%. It is a measure of what sales activity (what movement of goods or services) one gets from the capital employed. Obviously, a higher multiple is seen as being more efficient but the multiple will very much depend on the type of industry being analyzed. For instance, an engineering company, with high amounts of capital employed invested in plant and machinery would typically have a low multiple, 2:1 being quite common, whereas a service company, often with very little capital employed

would have a high multiple, say, 4:1. Whatever the type of business, the drive will always be to produce a higher multiple as this affects the return on capital employed – the primary ratio.

Once these two subsidiary ratios have been calculated, it can be seen that the:

Net Profit % x Asset Turnover = Return on Capital Employed.

It is important to be aware of this arithmetical link. For example, if net profit % falls due to the market place competition, one way of maintaining returns would be to become more efficient, that is, to increase sales from the capital employed used ('make the assets sweat') or reduce the capital employed. This is not surprising and it is manifested in the common practice of out-sourcing or sub-contracting. The aim is to reduce capital employed at every turn – reduce tangible fixed assets – buildings, shops, equipment employed – and keep levels of stocks and debtors well under control.

Overhead or expense analysis

Further ratios under net profit % are obtained from an analysis of the overhead or expense headings, for example, wages to sales; motor costs to sales; heat and light or occupancy costs to sales; telephone/fax costs to sales, etc. These ratios are used throughout industries for control purposes.

Asset turnover

A further analysis of asset turnover is given by looking at turnover or sales to fixed assets; turnover or sales to stock; turnover or sales to debtor; turnover or sales or, more correctly, cost of sales to creditors.

Stock market measures

Another area of performance measurement is that of measuring the performance of a company by its performance in relation to other listed or quoted companies – how does it perform in relation to the market?

The following terms and ratios are the principal ones used when considering stock market performance.

Share values

There are three share values commonly quoted and they are as follows:

1. Nominal (par) value
2. Book (asset) value
3. Market value

Nominal (par) value

The nominal value is largely a notional low figure arbitrarily placed on a company's stock. It serves to determine the value of 'issued common stock'.

Book value

This value is arrived at by dividing the number of issued shares into the owners' funds.

Market value

Market capitalisation is the market value times the number of shares in issue). This is the price quoted in the Stock Exchange for a public company or an estimated price for a non-quoted company. On the Stock Exchange the figure changes daily in response to actual or anticipated results and overall sentiment of the market.

Earnings per share (EPS)

Earnings per share is one of the most widely quoted performance measures when there is a discussion of a company's performance or share value. The profit used in the calculation is the profit available to shareholders after all other claimants have been satisfied. The most common prior charges in the profit and loss account are interest and tax. The profit is divided by the number of issued shares to calculate the value of

earnings per share. This figure tells us what profit has been earned by the shareholder for every share held. There is an Accounting Standard which further defines profit and number of shares as it may be possible to manipulate these figures.

One important piece of additional information is that the 'fully diluted' EPS should be shown. Fully diluted means that if all options on shares, to directors, employees or to those holders of loans which can be converted into ordinary shares were taken up then obviously the number of shares in existence would increase and the EPS figure would fall. A much lower fully diluted EPS figure indicates many options in existence or a high level of convertible loans.

Note: IAS 33 Earnings per share aims to prevent manipulation of this important ratio.

Dividend cover

This is a ratio of profits available for ordinary shareholders expressed as a multiple of the total dividends paid and payable.

Earnings yield and dividend yield

The yield on a share can be expressed as the return it provides in terms of earnings or dividends as a percentage of the current share price.

Price to earnings ratio (PE ratio)

The price to earnings ratio is a widely quoted measure of share value. The share price is divided by the EPS figure.

Market to book ratio

The ratio relates the total market capitalisation of the company to the shareholders' funds.

Section Three: Creative accounting

One of the prime aims of the Standards is to prevent creative accounting. Thus, what is shown here should not occur in practice. The purpose of this section is to help readers understand some of the methods that have been (or might still be) used to manipulate or miss-represent financial statements and the figures therein.

How can financial statements be distorted?

Quite easily:

- Over-stated good news under-stated bad news
- Over-stated asset and income amounts under-stated liabilities and expenses

Some examples:

Probably the most common abuses are to ignore the matching concept – bring income in early or leave costs un-accrued, treat expenses as assets – capitalise costs as tangible fixed assets.

Another means of being creative with figures is to omit figures altogether – especially to take assets, and thus the contra liabilities, off the balance sheet. This is exactly what was behind the 2008 banking crisis – huge amounts of assets (which turned out to be 'toxic') not shown on balance sheets – and also the contra liabilities.

Two common methods of creativity are outlined below. Omitting leased assets and the associated liabilities and not consolidating subsidiaries. Again, it must be stated that the Standards, properly applied should prevent such practices.

Off balance sheet items – the issues

There are two main issues in practice. Understatement of the capital employed and understatement of the liabilities of a business. The former is important as assets effectively owned and certainly managed by the business are omitted, the latter as real liabilities of the business are omitted – they are off the balance sheet that is hidden.

Omitting off balance sheet assets and liabilities results in distortion of important performance measures such as return on investment (ROI) and gearing.

Leased assets – an example

A **The apparent position ignoring the leased assets and the liability to the leasing company.**

The contention is that the lease charges are simply expenses to be paid as incurred. The example shows lease charges of 125 per year and minimal depreciation related to the 8 of equipment shown. The apparent return is 24% and gearing is 25%. *See over.*

Balance sheet as at 21 March 20X4 **A**

Tangible fixed assets			
Land and property			200
Equipment		a	8
			208
Net current assets – working capital			70
Total assets less current liabilities			
Capital employed		b	**278**
Financed by:			
Creditors: amounts falling due after more than one year (long term liabilities)		c	70
Shareholders equity			
Share capital	50		
Profit and loss account	158	d	
			208
		e	**278**

Profit and loss account for the year ended 31 March 20X4 – extract

Operating profit for year before depreciation	f	200
Leasing charges	g	(125)
Depreciation/amortisation charge	h	(2)
Interest/finance charge	i	(5)
Net operating profit before taxation	j	68

Return on capital employed (ROCE) =

$$\frac{\text{operating profit for year}}{\text{capital employed}} \quad \frac{i}{\text{bore}} \quad \frac{68}{278} = \mathbf{24\%}$$

Gearing =

$$\frac{\text{long term abilities}}{\text{+ Long term liabilities}} \quad \frac{c}{e} \quad \frac{70}{278} = \mathbf{25\%}$$

B However, what should the accounts really show?

The equipment is leased for a period of 3 years minimum (the company is committed to rent the equipment and make the 36 monthly payments). The arms length cost of the equipment was 300,000 when purchased at the beginning of the year. *See over.*

B

Balance sheet as at 21 March 20X4

Tangible fixed assets			
Land and property			200
Equipment		a	208
			408
Net current assets – working capital			70
Total assets less current liabilities			
Capital employed		b	**478**
Financed by:			
Creditors: amounts falling due after more than one year (long term liabilities)		c	277
Shareholders equity			
Share capital	50		
Profit and loss account	158	d	
			201
		e	**478**

Profit and loss account for the year ended 31 March 20X4 – extract

Operating profit for year before depreciation	f	200
Leasing charges	g	0
Depreciation/amortisation charge	h	(102)
Interest/finance charge	i	(37)
Net operating profit before taxation	j	61

Return on capital employed (ROCE) =

operating profit for year	i	61	=	**13%**
capital employed	bore	478		

Gearing =

long term abilities	c	277	=	**58%**
Shareholders' equity + Long term liabilities	e	478		

In substance the company is purchasing the equipment over 3 years. At the end of the first year the equipment would be written down to 200,000 (100,000 depreciation charge). A portion of the 'loan' of 300,000 at the start of the year would be repaid and there would be an interest charge on the loan. If the real substance of the transactions is recorded then the return on capital actually employed falls to 13% and the gearing when the loan liabilities are included is 58%

Note: The figures are approximations of what would really pertain; it is the effect of off balance sheet leasing that is important.

In summary

The reasons for removing assets from the balance sheet are two fold.

- The first is to reduce borrowing and thus apparent levels of gearing.
- The second is to reduce apparent capital employed and thus increase the return on capital employed ratio. This gives the impression that the business is performing better than it really is.

Reducing apparent levels of borrowing is one of the principal reasons for PFI (Private Financial Initiatives) PPP (Public Private Partnerships). This approach to funding public assets is popular with governments of whatever persuasion – they say they are borrowing less. The principal benefit of PFI or PPP is held to be that the private sector will be more efficient at building and operating assets than government bureaucracies. This may well be true but it does not alter the fact that governments are committing citizens to the liability of having to spend cash over a number of years. The governments are indirectly borrowing money, at probably much higher rates than those at which sound governments could borrow. Just like their private sector counterparts governments want to impress with the illusion of low borrowing.

Consolidating subsidiaries – an example

A group of companies has a parent or holding company that owns investments in one or more subsidiary companies. The parent company may trade in its own name, but frequently the parent is primarily an investment company. A balance sheet for such a parent company (A) is shown below:

Parent

If there was no requirement to consolidate and produce group or consolidated accounts then shareholders and other interested parties would have to gather together the accounts for the parent and subsidiaries, and combine them to get an overall view. In this example, the parent A has one subsidiary B shown below. Note: B has a significantly higher amount of assets and liabilities than the parent A.

Balance Sheet as at 31 March 201X			A
	parent		
Non-current assets			
Investment fixed assets		20	e
Current Assets	45		g
Creditors: amounts falling due in less than one year within one year - (current liabilities)	(39)		h
		6	I
Capital employed Total assets less current liabilities		26	j
Creditors: amounts falling due after more than one year (long term liabilities)		2	k
Shareholders Equity			
Share capital		10	m
Profit & Loss account		14	o
		26	p

Subsidiary

Balance Sheet as at 31 March 201X			B
	subsidiary		
Non-current assets			
Tangible fixed assets			
Land & property	150		a
Equipment -leased	260		b
		410	c
Current Assets	341		g
Creditors: amounts falling due in less than one year within one year - (current liabilities)	(290)		h
		51	I
Capital employed Total assets less current liabilities		461	j
Creditors: amounts falling due after more than one year (long term liabilities)		440	k
Shareholders Equity			
Share capital		20	m
Profit & Loss account		1	o
		461	p

Company law in the UK and most countries (supported by Standards IAS 22 and IAS 27) requires that a set of group or consolidated accounts are produced at each year end. Note: the accounting records for the business transactions are held in the parent and subsidiaries accounts. Accounts have to be produced for these entities. The group accounts are a year end creation. In simple terms the figures are added together, but with the elimination of the investment of the parent against the equity of the subsidiary – otherwise there would be double-counting!

The process for this simple example is shown below and the group balance sheet (C) is produced.

One way of hiding assets and maybe more significantly the contra liabilities is NOT to consolidate subsidiaries. This was part of the Enron scam. Entities that were controlled by the parent Enron were owned in a devious fashion in special purpose vehicles that meant they did not appear to be wholly owned subsidiaries and thus assets and huge amounts of liabilities – debt were left off Enron's balance sheet.

Group Balance Sheet as at 31 March 201X	parent			subsidiary		C group
Non-current assets						
Tangible fixed assets						
Land & property	0		a	150		
Equipment			b	260		
		0	c		410	410
Investment fixed assets		20	e	0		
Current Assets	45		g	341		
Creditors: amounts falling due in less than one year within one year - (current liabilities)	(39)		h	(290)		
		6	I		51	57
Capital employed Total assets less current liabilities		26	j		461	467
Creditors: amounts falling due after more than one year (long term liabilities)		2	k		440	442
Shareholders Equity						
Share capital		10	m		0	10
Profit & Loss account		14	o		1	15
		26	p		441	467

Financial instruments

What are the issues?

A. Classification – are they debt or equity – classification affects gearing or leverage.

B. Off balance sheet assets and liabilities – derivatives.

C. Hedging – covering exposure to risk – or taking risks – gambling!

D. Disclosure of the risks entered into.

Standards aim to address the issues by requiring disclosure, requiring derivatives (that generally have no value at inception) to be shown in the accounts. IAS 39 – Financial Instruments: recognition and measurement was and is objected to because it requires recognition of many off-balance sheet items at fair values.

The principles behind IAS 39 can be considered as follows:

A. Classification is a liability debt or equity

Equity is "free" i.e. does not have to pay interest, although shareholders do expect a return – dividends and/or capital growth. Equity (risk capital) is last in line for repayment on liquidation. Loans are liabilities – an obligation to transfer economic benefits as a result of past transactions or events (usually receipt of cash when the loan is granted). Thus loans are a clear liability and also require interest to be paid – an expense.

The correct classification is vital – the Standards aim to clearly define what is and is not equity.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.

Note: commodity contracts are also financial instruments unless the commodity contracts are those of a normally functioning commodity trading company.

An equity instrument is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities.

B. Off balance sheet assets and liabilities

The Standard's requirement that financial assets and liabilities (apart from genuine hedging situations and where financial assets or liabilities are to be held to maturity) should be re-valued to fair value at each balance sheet date is the main objection of many to the Standard. They, maybe rightly, argue that the financial assets and liabilities that they hold are part of a longer term, dynamic portfolio of net investment – the values should not just be viewed on one particular day. They argue too, again rightly, that the requirement to revalue to fair value each year will probably give rise to wide fluctuations in balance sheet values and net income. But to ignore values all together and wait until settlement of financial assets and liabilities may hide or at least ignore some nasty (or possibly positive) surprises.

A derivative is a financial instrument whose value depends on the values of other, more basic underlying variables. Commonly these variables are the prices of traded assets – shares, oil or currencies. The issue here is that there may be no liability at present and the hope is that the transactions entered into will yield a gain. But there may be significant potential losses.

The definitions of assets and liability from the IASB Framework catch items (financial instrument contracts) that give rise to probable future economic benefits or probable future sacrifices.

No one could dispute that only items that meet the definitions of assets and liabilities should be recognised as such in the balance sheet. Thus, financial instruments and non-financial derivatives create rights and obligations that meet the definitions of assets or liabilities and, as a result, should be recognised in financial statements.

Once a financial instrument has to be recognised the next question is at what value? Should it be at original, historic (maybe nil) value? Should it be at market value? But is there a market? The IASB and FASB have a clear penchant for 'fair values' – that is the latest, where possible market,

values. Those that object to 'fair value' would probably also object to any value. 'Fair value' at what can be considered an arbitrary or artificial time – a year end may not be at all representative of the settlement figure but is at least 'correct' at that time!

The standard setters are working hard to simplify (IFRS 9) classifications of financial instruments and give detailed guidance on how to consistently estimate fair values.

C. Hedging

Hedging (as in hedge your bets) means having matched assets and liabilities where the change in the vale of one will be covered or off-set by a compensating change in the other's value.

A common use of hedging is where investments are made in one currency and the financing is obtained in the same currency or a currency that is linked to the currency of the investment – if the value of the investment falls, then the amount of financing to be repaid falls by an equal amount. However businesses may also speculate on currency movements. There may be an unrelated compensating asset or liability, but there is no true hedge in this case.

Offsetting – IAS 1 Presentation of financial Statements – para 32

Assets and liabilities, and income and expenses, shall not be offset unless required or permitted by a Standard or an Interpretation. It is important that assets and liabilities, and income and expenses, are reported separately.

The Standards set out strict rules for hedging to be allowed. Key points are that hedge arrangements have to be acknowledged before inception and then regularly tested to check that the hedging is working.

D. The risks entered into

It is very important that users of accounts are made aware of any risks an entity is exposed to. The standards, particularly IFRS7 require entities

to provide disclosures in their financial statements that enable users to evaluate:

a) the significance of financial instruments for the entity's financial position and performance; and

b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

Users of financial statements and investors should then be able to ascertain whether a company has financial instruments appropriate to its trade and the executives stated strategies.

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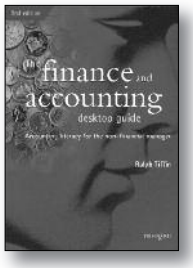

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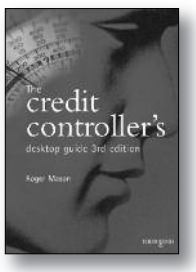

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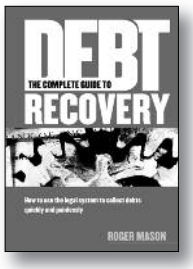

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Inside Back Cover

FULLY UPDATED TO INCLUDE ALL THE NEW AND INDUSTRY-SPECIFIC STANDARDS ISSUED UP TO AUTUMN 2010

The third edition of Ralph Tiffin's lucid guide explains all current international financial reporting standards in clear and simple terms and incorporates all the new and industry-specific standards issued to date, including:

- IFRS 6 Exploration for and evaluation of mineral resources
- IFRS 7 Financial Instruments: disclosures
- IFRS 8 Operating Segments
- IFRS 9 Financial Instruments: a revamp being developed

The standards are in a constant state of change. It is vitally important for finance directors, accountants and other professional advisers to understand the implication of these recent changes.

IFRS 9 aims to simplify the classification of and clarify the accounting for financial instruments. Specific industries now have their own standards – and more will follow. References are made to significant changes ahead, e.g. with respect to accounting for leases.

As in the previous editions, Ralph Tiffin explains the accounting ideas behind each of the standards and their effect on financial statements. He summarises the issues underlying standard practice, and clarifies the accounting and disclosure requirements as well as the practical problems of compliance. You will be better able to discuss the detail of each standard and appreciate when to seek professional guidance on the full standards.

The guide is designed for anyone in business connected with published accounts and internal reports, whether accountants or otherwise. As never before, professional advisers, directors and executives from functions other than finance are affected by the requirements of accounting standards.

RALPH TIFFIN is managing partner of a successful accountancy and consultancy practice. He has a wealth of experience of organizations throughout the world. He is the author of several books including *The Finance and Accounting Desktop Guide*, also published by Thorogood.

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