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MODULE 4. PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

THEME 12. CONCEPTS THAT UNDERLIE THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

1. Read the articles and discuss

1. Accounting Qualities

Financial information is useful when it is *relevant* and *represents faithfully* what it purports to represent.
The usefulness of financial information is enhanced if it is *comparable*, *verifiable*, *timely* and *understandable*.

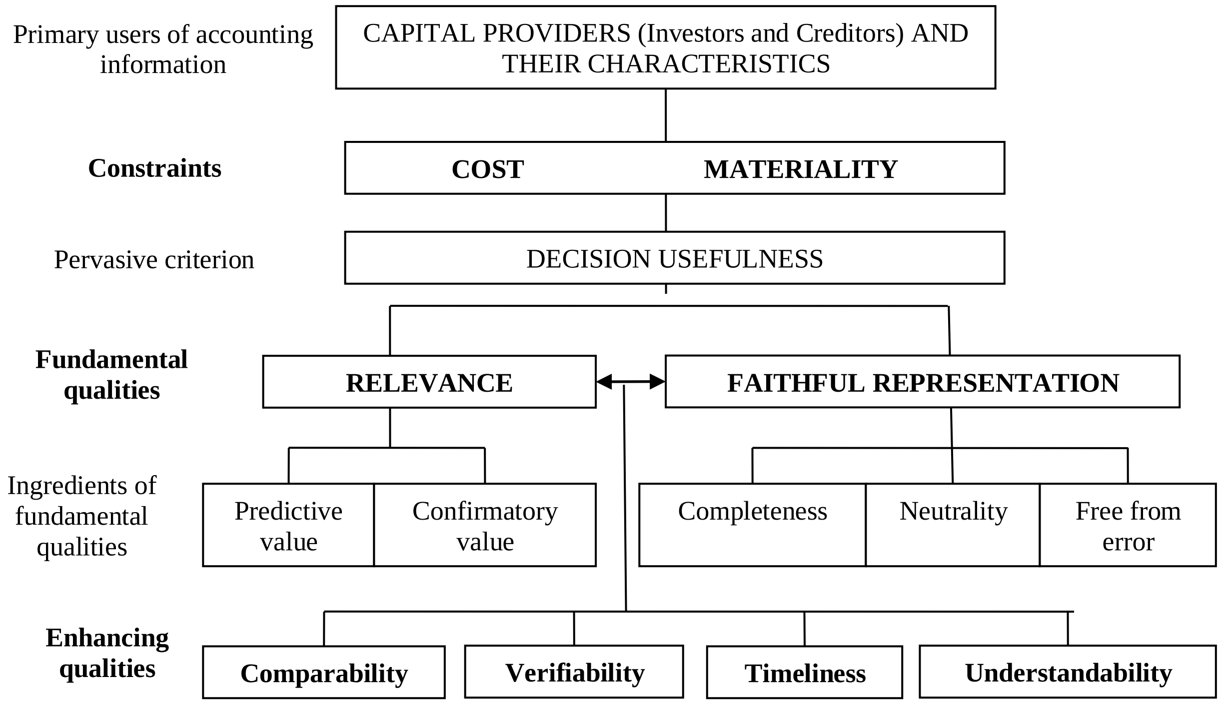


ILLUSTRATION Hierarchy of Accounting Qualities

Fundamental Qualitative Characteristics

1) ___________________

_______________ information is capable of making a difference in the decisions made by users. _____________ requires financial information to be related to an economic decision. Otherwise, the information is useless.

Financial information is useful if it has *predictive value* and *confirmatory value*. Predictive value helps users in predicting or anticipating future outcomes. Confirmatory value enables users to check and confirm earlier predictions or evaluations.

Materiality is an aspect of relevance which is entity-specific. It means that what is material to one entity may not be material to another. It is relative. Information is material if it is significant enough to influence the decision of users.

Materiality is affected by the *nature* and *magnitude (or size)* of the item.

2) ______________________

The financial information in the financial reports should represent what it purports to represent. Meaning, it should show what really are present and what really happened, as the case may be.

There are three characteristics of faithful representation: 1. Completeness (adequate or full disclosure of all necessary information), 2. Neutrality (fairness and freedom from bias), and 3. Free from error (no inaccuracies and omissions).

<u>Enhancing Qualitative Characteristics</u>

1) _______________

___________ information enables comparisons within the entity and across entities. When comparisons are made *within the entity,* information is compared from one accounting period to another. For example: income is compared for the years 2012, 2013, and 2014. Comparability of information *across entities* enables analysis of similarities and differences between different companies.

2) _____________

___________ helps to assure users that information represents faithfully what it purports to represent. Financial information is supported by evidence and independent individuals can check them to see whether such information is faithfully represented. In other words, information is verifiable if it can be audited.

3) ______________

____________ means providing information to decision-makers in time to be capable of influencing their decisions. It shouldn't be significantly delayed or else it will be of little or no value.

4) ____________

____________________ requires financial information to be understandable or comprehensible to users with reasonable knowledge of business and economic activities. To be understandable, information should be presented clearly and concisely. However, it is improper to exclude complex items just to make the reports simple and understandable.

Other Characteristics of Accounting Information

When financial reports are generated by professional accountants, we have certain expectations of the information they present to us:

1. We expect the accounting information to be **reliable, verifiable, and objective**.
2. We expect **consistency** in the accounting information.
3. We expect **comparability** in the accounting information.

1. Reliable, Verifiable, and Objective

In addition to the basic accounting principles and guidelines listed in Part 1, accounting information should be reliable, verifiable, and objective. For example, showing land at its original cost of $10,000 (when it was purchased 50 years ago) is considered to be more **reliable, verifiable,** and **objective** than showing it at its current market value of $250,000. Eight different accountants will wholly agree that the original cost of the land was $10,000—they can read the offer and acceptance for $10,000, see a transfer tax based on $10,000, and review documents that confirm the cost was $10,000. If you ask the same eight accountants to give you the land's *current* value, you will likely receive eight different estimates. Because the current value amount is less reliable, less verifiable, and less objective than the original cost, the original cost is used.

The accounting profession has been willing to move away from the **cost principle** if there are reliable, verifiable, and objective amounts involved. For example, if a company has an investment in stock that is actively traded on a stock exchange, the company may be required to show the current value of the stock instead of its original cost.

2. Consistency

Accountants are expected to be **consistent** when applying accounting principles, procedures, and practices. For example, if a company has a history of using the **FIFO cost flow assumption**, readers of the company's most current financial statements have every reason to expect that the company is continuing to use the FIFO cost flow assumption. If the company changes this practice and begins using the **LIFO cost flow assumption**, that change must be clearly disclosed.

3. Comparability

Investors, lenders, and other users of financial statements expect that financial statements of one company can be compared to the financial statements of another company in the same industry. **Generally accepted accounting principles** may provide for **comparability** between the financial statements of different companies. For example, the **FASB** requires that expenses related to research and development (R&D) be expensed when incurred. Prior to its rule, some companies expensed R&D when incurred while other companies deferred R&D to the balance sheet and expensed them at a later date.

2. Match these words with their meanings

Revenue Recognition Principle; Economic Entity Assumption; Going Concern Principle; Monetary Unit Assumption; Matching Principle; Materiality; Time Period Assumption; Conservatism; Cost Principle; Full Disclosure Principle

Basic Accounting Principle	What It Means in Relationship to a Financial Statement
1.	The accountant keeps all of the *business* transactions of a sole proprietorship separate from the business owner's *personal* transactions. For *legal* purposes, a sole proprietorship and its owner are considered to be one entity, but for accounting purposes they are considered to be two separate entities.
2.	Economic activity is measured in U.S. dollars, and only transactions that can be expressed in U.S. dollars are recorded. Because of this basic accounting principle, it is assumed that the dollar's purchasing power has not changed over time. As a result accountants ignore the effect of inflation on recorded amounts. For example, dollars from a 1960 transaction are combined (or shown with) dollars from a 2012 transaction.
3.	This accounting principle assumes that it is possible to report the complex

	and ongoing activities of a business in relatively short, distinct time intervals such as the five months ended May 31, 2012, or the 5 weeks ended May 1, 2012. The shorter the time interval, the more likely the need for the accountant to estimate amounts relevant to that period. For example, the property tax bill is received on December 15 of each year. On the income statement for the year ended December 31, 2011, the amount is known; but for the income statement for the three months ended March 31, 2012, the amount was not known and an estimate had to be used. It is *imperative* that the time interval (or period of time) be shown in the heading of each income statement, statement of stockholders' equity, and statement of cash flows. Labeling one of these financial statements with "December 31" is not good enough—the reader needs to know if the statement covers the *one week* ended December 31, 2011 the *month* ended December 31, 2011 the*three months* ended December 31, 2011 or the *year ended* December 31, 2011.
4.	From an accountant's point of view, the term "cost" refers to the amount spent (cash or the cash equivalent) when an item was *originally* obtained, whether that purchase happened last year or thirty years ago. For this reason, the amounts shown on financial statements are referred to as *historical* cost amounts. Because of this accounting principle asset amounts are *not* adjusted upward for inflation. In fact, as a general rule, asset amounts are not adjusted to reflect *any* type of increase in value. Hence, an asset amount does not reflect the amount of money a company would receive if it were to sell the asset at today's market value. (An exception is certain investments in stocks and bonds that are actively traded on a stock exchange.) If you want to know the current value of a company's long-term assets, you will not get this information from a company's financial statements - you need to look elsewhere, perhaps to a third-party appraiser.
5.	If certain information is important to an investor or lender using the financial statements, that information should be disclosed within the statement or in the notes to the statement. It is because of this basic accounting principle that numerous pages of "footnotes" are often attached to financial statements. As an example, let's say a company is named in a lawsuit that demands a significant amount of money. When the financial statements are prepared it is not clear whether the company will be able to defend itself or whether it might lose the lawsuit. As a result of these conditions and because of the full disclosure principle the lawsuit will be described in the notes to the financial statements. A company usually lists its significant accounting policies as the first note to its financial statements.
6.	This accounting principle assumes that a company will continue to exist long enough to carry out its objectives and commitments and will not liquidate in the foreseeable future. If the company's financial situation is such that the accountant believes the company will *not* be able to continue on, the accountant is required to disclose this assessment. The going concern principle allows the company to defer some of its prepaid expenses until future accounting periods.
7.	This accounting principle requires companies to use the accrual basis of accounting. The matching principle requires that expenses be matched with revenues. For example, sales commissions expense should be reported in the period when the sales were made (and not reported in the period when the

	commissions were paid). Wages to employees are reported as an expense in the week when the employees worked and not in the week when the employees are paid. If a company agrees to give its employees 1% of its 2012 revenues as a bonus on January 15, 2013, the company should report the bonus as an expense in 2012 and the amount unpaid at December 31, 2012 as a liability. (The expense is occurring as the sales are occurring.) Because we cannot measure the future economic benefit of things such as advertisements (and thereby we cannot match the ad expense with related future revenues), the accountant charges the ad amount to expense in the period that the ad is run.
8.	Under the accrual basis of accounting (as opposed to the cash basis of accounting), revenues are recognized as soon as a product has been sold or a service has been performed, regardless of when the money is actually received. Under this basic accounting principle, a company could earn and report $20,000 of revenue in its first month of operation but receive $0 in actual cash in that month. For example, if ABC Consulting completes its service at an agreed price of $1,000, ABC should recognize $1,000 of revenue as soon as its work is done - it does not matter whether the client pays the $1,000 immediately or in 30 days. Do not confuse *revenue* with a *cash receipt*.
9.	Because of this basic accounting principle or guideline, an accountant might be allowed to violate another accounting principle if an amount is insignificant. Professional judgement is needed to decide whether an amount is insignificant or immaterial. An example of an obviously immaterial item is the purchase of a $150 printer by a highly profitable multi-million dollar company. Because the printer will be used for five years, the *matching* principle directs the accountant to expense the cost over the five-year period. The materiality guideline allows this company to violate the matching principle and to expense the entire cost of $150 in the year it is purchased. The justification is that no one would consider it misleading if $150 is expensed in the first year instead of $30 being expensed in each of the five years that it is used. Because of materiality, financial statements usually show amounts rounded to the nearest dollar, to the nearest thousand, or to the nearest million dollars depending on the size of the company.
10.	If a situation arises where there are two acceptable alternatives for reporting an item, conservatism directs the accountant to choose the alternative that will result in less net income and/or less asset amount. Conservatism helps the accountant to "break a tie." It does not direct accountants to be conservative. Accountants are expected to be unbiased and objective. The basic accounting principle of conservatism leads accountants to anticipate or disclose losses, but it does not allow a similar action for gains. For example, *potential* losses from lawsuits will be reported on the financial statements or in the notes, but *potential* gains will not be reported. Also, an accountant may write inventory *down* to an amount that is lower than the original cost, but will not write inventory *up* to an amount higher than the original cost.

3. Read the articles and discuss

CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

1. Financial capital maintenance

A financial concept of capital is whereby the capital of the entity is linked t the net assets, which is the equity of the entity.

When a financial concept of capital is used, a profit is earned only if the financial amount of the net assets at the and of the period is greater than the net assets at the beginning of the period, adjusted of course for any distributions paid to the owners during the period, or any equity capital raised.

The main concern of the users of the financial statements is with the maintenance of the financial capital of the entity.

Assets – Liabilities = Equity

Opening equity (net assets) + Profit – Distributions = Closing equity (net assets)

There are also two ways of looking at financial capital maintenance:

- money financial capital maintenance, and
- real financial capital maintenance

Under the money financial capital maintenance, the profit is measured if the closing net assets is greater than the opening net assets, and the net assets in both cases are measured at historical cost.

This method doesn't take into consideration any inflation or the time value of money.

Therefore under the real financial capital maintenance, the entity makes a net profit if the closing net assets are greater than the opening net assets, and both of these figures are measured at current prices.

To do this we increase the opening net asset figure by the inflation rate.

2. Physical capital maintenance

A physical concept of capital is one where the capital of an entity is regarded as its production capacity, which could be based on its units of output.

When a physical concept of capital is used, a profit is earned only if the physical production capacity (or operating capability) of the entity at the end of the period is greater than the production capacity at the beginning of the period, adjusted for any distributions paid to the owners during the period, or any equity capital raised.

The main concern of users of its financial statements is with the maintenance of the operating capability of the entity.

A financial concept of capital should be used if the users of the financial statements are mostly concerned with the maintenance of their invested capital, or the purchasing power of the invested capital.

A physical concept of capital should be used if the users of the financial statements are mostly concerned with the operating capacity of the entity, and current value accounting.

NB. Profits will usually be higher when the financial concept of capital is used compared to the physical concept of capital. This is due to the inflation adjustment.

Exam Tip: worked out example

Let's look at an example of the physical concept of capital in use.

- An entity is established on 1 January 20X1 with 20,000 ordinary shares at €1 each.
- It then buys €20,000 worth of stock, which is sells during the year for €25,000.
- There were no other transactions during the period.
- At the end of the year the purchase price of the stock increased on €23,000.

Answer:

- Using the physical maintenance concept, the profit for the reporting period is _________________.
- If the financial capital maintenance concept is used, the profit for the year is €5,000, but if the company paid out the €5,000 profit to shareholders, it would be unable to buy the same stock again as the purchase price has risen.
- To keep the operating capability of the entity the same, profit is measured as sales less the replacement cost of the goods sold.

4. Complete the following sentences

1) Accounting Principles

1. General guidelines. _____________

2. The __________ unit assumption means transactions of U.S. companies are reported in dollars.

3. The cost principle is often described as the __________ cost principle.

4. The concept of _________________ allows for the violation of an accounting principle when the amounts are insignificant.

5. The __________ entity assumption results in business transactions being kept separate from a sole proprietor's personal transactions.

6. Full __________ is achieved through the notes to the financial statements.

7. This assumption justifies quarterly financial statements. __________

8. Defined as the cash or cash equivalent amount at the time of a transaction. __________

9. Accrual accounting is related to this principle. __________

10. The __________ concern assumption is that an enterprise will continue on long enough to carry out its objectives and commitments.

11. Communicating the significant accounting policies in the first note to the financial statements is related to the full ______________ principle.

12. Under the __________-basis of accounting, revenues are reported on the income statement in the period in which they are earned.

13. Part of the _______________ unit assumption is that the U.S. dollar retains its purchasing power over time.

2) Elements of Financial Statements

1. Probable future economic benefits is part of the definition of ___________.

2. Inflows from delivering goods or services and other activities that are part of a company's main operations. ___________

3. The residual interest in the assets of an entity after deducting liabilities. ___________

4. _______________ by owners increase their ownership interest.

5. Probable future sacrifices resulting from a past transaction or event. ___________

6. Outflows, using up of assets, or incurring a liability as the result of earning revenues. ___________

7. Other ____________________ income includes unrealized gains or losses on available-for-sale securities.

8. The net outflows resulting from peripheral transactions. ___________

9. ___________________ to owners will decrease owner's equity.

10. The net increases in equity from peripheral transactions. ___________

THEME 13. PRESENTATION OF FINANCIAL STATEMENTS

1. Read this article to learn about the features, importance and limitations of financial statements.

Features of Financial Statements:

1. The Financial Statements should be relevant for the purpose for which they are prepared. Unnecessary and confusing disclosures should be avoided and all those that are relevant and material should be reported to the public.

2. They should convey full and accurate information about the performance, position, progress and prospects of an enterprise. It is also important that those who prepare and present the financial statements should not allow their personal prejudices to distort the facts.

3. They should be easily comparable with previous statements or with those of similar concerns or industry. Comparability increases the utility of financial statements.

4. They should be prepared in a classified form so that a better and meaningful analysis could be made.

5. The financial statements should be prepared and presented at the right time. Undue delay in their preparation would reduce the significance and utility of these statements.

6. The financial statements must have general acceptability and understanding. This can be achieved only by applying certain "generally accepted accounting principles" in their preparation.

7. The financial statements should not be affected by inconsistencies arising out of personal judgment and procedural choices exercised by the accountant.

8. Financial Statements should comply with the legal requirements if any, as regards form, contents, and disclosures and methods. In India, companies are required to present their financial statements according to the Companies Act, 1956.

Importance of Financial Statements:

The importance of financial statements lies in their utility to satisfy the varied interest of different categories of parties such as management, creditors, public, etc.

1. Importance to Management:

Increase in size and complexities of factors affecting the business operations necessitate a scientific and analytical approach in the management of modern business enterprises.

The management team requires up to date, accurate and systematic financial information for the purposes. Financial statements help the management to understand the position, progress and prospects of business vis-a-vis the industry.

By providing the management with the causes of business results, they enable them to formulate appropriate policies and courses of action for the future. The management communicates only through these financial statements, their performance to various parties and justify their activities and thereby their existence.

A comparative analysis of financial statements reveals the trend in the progress and position of enterprise and enables the management to make suitable changes in the policies to avert unfavorable situations.

2. Importance to the Shareholders:

Management is separated from ownership in the case of companies. Shareholders cannot, directly, take part in the day-to-day activities of business. However, the results of these activities should be reported to shareholders at the annual general body meeting in the form of financial statements.

These statements enable the shareholders to know about the efficiency and effectiveness of the management and also the earning capacity and financial strength of the company.

By analyzing the financial statements, the prospective shareholders could ascertain the profit earning capacity, present position and future prospects of the company and decide about making their investments in this company.

Published financial statements are the main source of information for the prospective investors.

3. Importance to Lenders/Creditors:

The financial statements serve as a useful guide for the present and future suppliers and probable lenders of a company.

It is through a critical examination of the financial statements that these groups can come to know about the liquidity, profitability and long-term solvency position of a company. This would help them to decide about their future course of action.

4. Importance to Labour:

Workers are entitled to bonus depending upon the size of profit as disclosed by audited profit and loss account. Thus, P & L a/c becomes greatly important to the workers. In wages negotiations also, the size of profits and profitability achieved are greatly relevant.

5. Importance to the Public:

Business is a social entity. Various groups of society, though directly not connected with business, are interested in knowing the position, progress and prospects of a business enterprise.

They are financial analysts, lawyers, trade associations, trade unions, financial press, research scholars and teachers, etc. It is only through these published financial statements these people can analyze, judge and comment upon business enterprise.

6. Importance to National Economy:

The rise and growth of corporate sector, to a great extent, influence the economic progress of a country. Unscrupulous and fraudulent corporate managements shatter the confidence of the general public in joint stock companies, which is essential for economic progress and retard the economic growth of the country.

Financial Statements come to the rescue of general public by providing information by which they can examine and assess the real worth of the company and avoid being cheated by unscrupulous persons.

The law endeavors to raise the level of business morality by compelling the companies to prepare financial statements in a clear and systematic form and disclose material information.

This has increased the confidence of the public in companies. Financial statements are also essential for the various regulatory bodies such as tax authorities, Registrar of companies, etc. They can judge whether the regulations are being strictly followed and also whether the regulations are producing the desired effect or not, by evaluating the financial statements.

Limitations of Financial Statements:

Most of the limitations are mainly due to the cumulative effect of recorded facts, accounting conventions and personal judgment on financial statements. Unless they are prepared specially they fail to reflect the current economic picture of business. As such, financial statements have a number of limitations.

The important limitations are as follows:

1. Information is Incomplete and Inexact:

The financial statements are interim reports usually prepared for an accounting period. Hence, the financial information as revealed by them is neither complete nor exact.

The true financial position or ultimate gain or loss, can be known only when the business is closed down.

2. Qualitative Information is Ignored:

Financial statements depict only those items of quantitative information that are expressed in monetary terms.

But, a number of qualitative factors, such as the reputation and prestige of the management with the public, cordial industrial relations and efficiency of workers, customer satisfaction, competitive strength, etc., which cannot be expressed in monetary terms , are not depicted by the financial statements.

However, these factors are essential for understanding the real financial condition and the operating results of the business.

3. Financial Statements Mainly Show Historical Information:

As the financial statements are compiled on the basis of historical costs, they fail to take into account such factors as the decrease in money value or increase in the price level changes. Since these statements deal with past data only, they are of little value in decision-making.

4. Financial Statements are Based on Accounting Concepts and Conventions.

Accounting concepts and conventions used the preparation of financial statements make them unrealistic.

For example the income statement prepared on the basis of the convention of conservatism fails to disclose the true income, for it includes probable losses and ignores probable income.

Similarly the value of fixed asset is shown in the balance sheet on the ‘going concern concept’. This means that the value of the asset rarely represents the amount of cash, which would be realized on liquidation.

5. Personal Judgment Influence Financial Statements:

Many items in the financial statements are left to the personal judgment of the accountant. For example, the method of inventory valuation, the method of depreciation the treatment of deferred revenue expenditure, etc., depend on the personal judgment of the accountant.

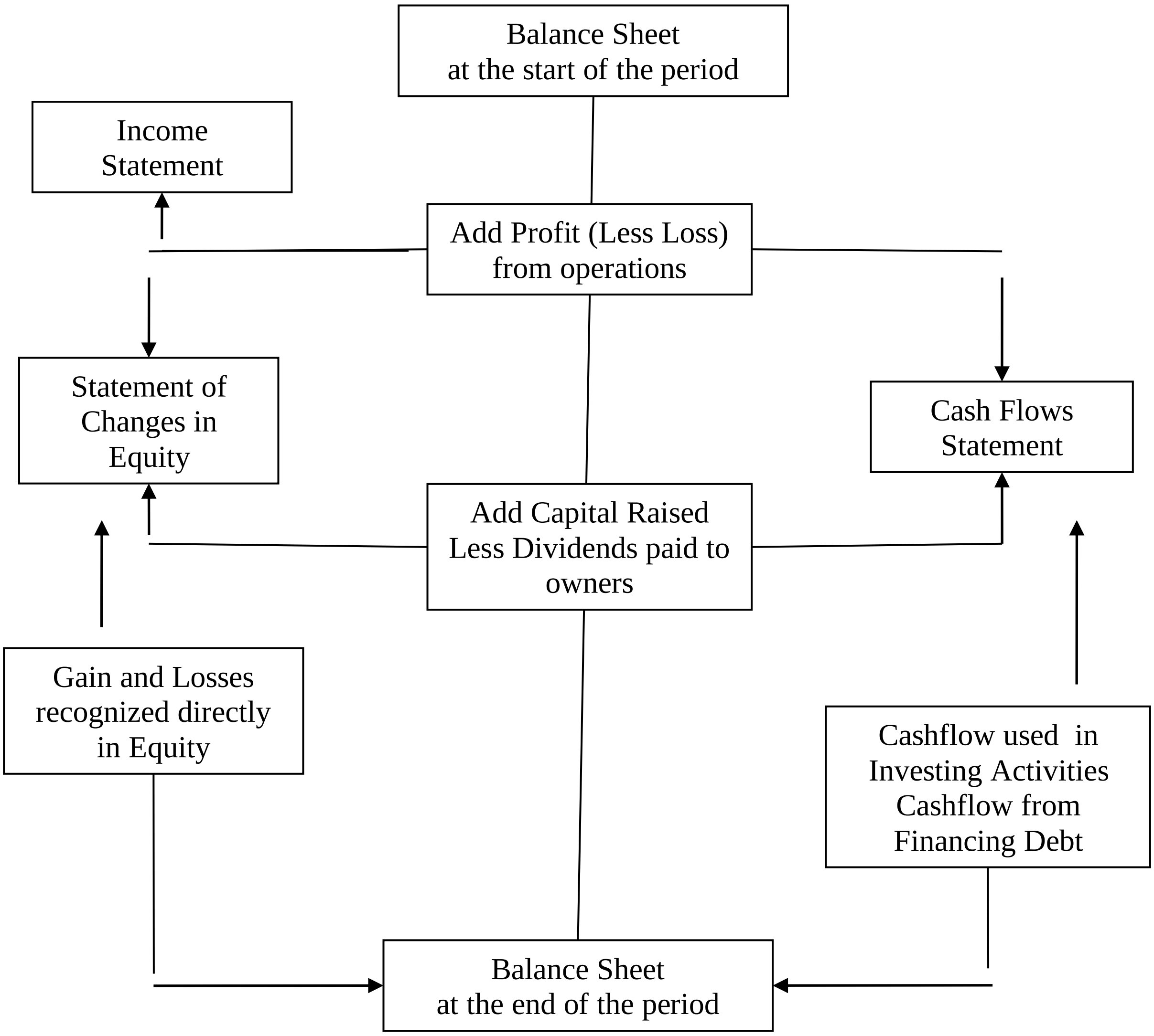
If it goes wrong, the real picture may be distorted. However, such indiscreet personal judgments are controlled to a certain extent by the convention of conservatism.

2. Read the articles and discuss

Relationship between Financial Statements

Explanation

Financial Statements reflect the effects of business transactions and events on the entity. The different types of financial statements are not isolated from one another but are closely related to one another as is illustrated in the following diagram.



Balance Sheet

Balance Sheet, or Statement of Financial Position, is directly related to the income statement, cash flow statement and statement of changes in equity.

Assets, liabilities and equity balances reported in the Balance Sheet at the period end consist of:

- Balances at the start of the period;
- The increase (or decrease) in net assets as a result of the net profit (or loss) reported in the income statement;
- The increase (or decrease) in net assets as a result of the net gains (or losses) recognized outside the income statement and directly in the statement of changes in equity (e.g. revaluation surplus);
- The increase in net assets and equity arising from the issue of share capital as reported in the statement of changes in equity;
- The decrease in net assets and equity arising from the payment of dividends as presented in the statement of changes in equity;
- The change in composition of balances arising from inter balance sheet transactions not included above (e.g. purchase of fixed assets, receipt of bank loan, etc).
- Accruals and Prepayments
- Receivables and Payables

Income Statement

Income Statement, or Profit and Loss Statement, is directly linked to balance sheet, cash flow statement and statement of changes in equity.

The increase or decrease in net assets of an entity arising from the profit or loss reported in the income statement is incorporated in the balances reported in the balance sheet at the period end.

The profit and loss recognized in income statement is included in the cash flow statement under the segment of cash flows from operation after adjustment of non-cash transactions. Net profit or loss during the year is also presented in the statement of changes in equity.

Statement of Changes in Equity

Statement of Changes in Equity is directly related to balance sheet and income statement.

Statement of changes in equity shows the movement in equity reserves as reported in the entity's balance sheet at the start of the period and the end of the period. The statement therefore includes the change in equity reserves arising from share capital issues and redemptions, the payments of dividends, net profit or loss reported in the income statement along with any gains or losses recognized directly in equity (e.g. revaluation surplus).

Cash Flow Statement

Statement of Cash Flows is primarily linked to balance sheet as it explains the effects of change in cash and cash equivalents balance at the beginning and end of the reporting period in terms of the cash flow impact of changes in the components of balance sheet including assets, liabilities and equity reserves.

Cash flow statement therefore reflects the increase or decrease in cash flow arising from:

- Change in share capital reserves arising from share capital issues and redemption;
- Change in retained earnings as a result of net profit or loss recognized in the income statement (after adjusting non-cash items) and dividend payments;
- Change in long term loans due to receipt or repayment of loans;
- Working capital changes as reflected in the increase or decrease in net current assets recognized in the balance sheet;
- Change in non current assets due to receipts and payments upon the acquisitions and disposals of assets (i.e. investing activities)

3. Choose the correct answer

1. Assets to be sold, consumed or realised as part of the entity's normal operating cycle are:

a) current assets;

b) non-current assets;

c) classified as current or non-current in accordance with other criteria.

2. When there is much variability in the duration of the entity's normal operating cycle, the operating cycle is measured at:

a) its mean value;

b) its median value;

c) twelve months;

d) three years.

3. Liabilities that an entity expects to settle in its normal operating cycle are:

a) classified as non-current liabilities;

b) classified as current or non-current liabilities in accordance with other criteria;

c) classified as current liabilities.

4. A dividend declared by the entity before its year-end and payable to its shareholders three months after the end of the reporting period is classified as:

a) a non-current liability;

b) a current liability;

c) equity;

d) a current asset.

5. Staff costs are:

a) administrative expenses;

b) distribution expenses;

c) cost of sales;

d) allocated to categories (a)–(c) above according to the function of the employee to which the particular staff cost relates.

6. Cash receipts from customers for the sale of goods are cash flows from:
a) operating activities;
b) investing activities;
c) operating or financing activities;
d) financing activities.

7. Payment of non-refundable purchase taxes on the purchase of property, plant and equipment are allocated as cash flows from:
a) operating activities;
b) investing activities;
c) financing activities;
d) operating or financing activities.

8. Cash payments to acquire the entity's own shares (ie treasury shares) are:
a) cash outflows from operating activities;
b) cash outflows from investing activities;
c) cash outflows from financing activities.

9. Cash proceeds from long-term borrowings are:
a) cash inflows from operating activities;
b) cash inflows from investing activities;
c) cash inflows from financing activities.

10. Interest and dividends received:
a) are cash inflows from operating activities;
b) are cash inflows from financing activities;
c) could be classified as operating or financing cash flows;
d) could be classified as operating or investing cash flows.

11. Cash receipts from the sale of an owner-operated plant are:
a) cash flows from financing activities;
b) cash flows from investing activities;
c) cash flows from operating activities.

12. The financial statement that reports the revenues and expenses for a period of time such as a year or a month is the
a) balance sheet;
b) income statement;
c) statement of cash flows.

13. The financial statement that reports the assets, liabilities, and stockholders' (owner's) equity at a specific date is the
a) balance sheet;
b) income statement;
c) statement of cash flows.

14. Under the accrual basis of accounting, revenues are reported in the accounting period when the

a) cash is received;

b) service or goods have been delivered.

15. Under the accrual basis of accounting, expenses are reported in the accounting period when the

a) cash is paid;

b) expense matches the revenues or is used up.

16. Assets are usually reported on the balance sheet at which amount?

a) cost;

b)current market value;

c) expected selling price.

17. Financial statements report the fair market value of a company.

a) True;

b) False.

THEME 14. STRUCTURE AND CONTENT OF FINANCIAL STATEMENTS

1. Fill in the table with a suitable word from the box

Additional Paid in Capital, Accumulated Depreciation, Investments, Goodwill, Accounts Receivable, Inventory, Intangible Assets, Unearned Revenues, Common Stock or Contributed Capital, Notes Receivable, Prepaid Expenses, Accounts Payable, Treasury Stock, Bonds Payable, Operating cycle, Retained Earnings, Property, Plant and Equipment, Supplies, Accrued Expense / Accrued Liabilities, ________ Payable, Current Maturities of Long Term Debt, Long Term Notes Payable and Long-term Debt

Name	Meaning
1.	Amounts customers owe the company for goods or services provided; normally collected in 30 to 90 days
2.	Items held only for sale to the customer
3.	Paid in advance before the service is provided; gives future benefit (rent, insurance)
4.	Items that are used up in day to day operations
5.	Amounts owed to the company; normally interest is charged and the note is repaid in longer than 3 months
6.	The company takes their excess cash and invests it in stocks or bonds to earn a return.
7.	Assets used long-term to generate revenues; they have physical substance (Buildings, Equipment, Autos, Land, Computers)
8.	The total amount for all prior years (cumulative) of depreciation expense for all prior periods. This is a contra account subtracted from plant, and equipment
9.	No physical substance - used long-term to generate revenues The company has the exclusive right to do something; Includes trademarks, copyrights, patents, franchises, goodwill
10.	Cash paid to purchase a company less Fair market value of net assets acquired
11.	Amounts owed to suppliers, normally paid in 30-60 days Suppliers are those who provide inventory or goods and services over and over again
12.	Both of these are expenses that have not yet been paid that the company owes – examples are: employee taxes, legal, advertising, bonuses, retirement plans
13.	Expenses incurred that have not yet been paid (Salaries, Rent, Interest, Taxes) If an amount is large enough, it gets its own line. If it is not large enough it will be included in accrued expenses.

14.	Cash received from customers before the good or service is provided. The company owes the customer a good/service
15.	The portion of long –term debt that will be repaid within 1 year
16.	Amounts owed to banks and other financing companies that will be paid later than one year from now Amounts due within a year are reported as current maturities of long term debt
17.	Amounts borrowed from investors; normally long-term
18.	Funds received from investors in exchange for ownership – common stock is reported at par value
19.	Amounts over and above par raised from investors from the sale of stock (ownership)
20.	Total of all (cumulative) profits and losses less dividends paid to owners
21.	The company buys and holds its own stock
22.	the time it takes a company to spend cash to do business and get the cash back again (buy inventory, pay expenses, sell to the customer and collect from the customer). Usually less than one year.

2. Read the articles and discuss

1. Statement of Financial Position

The statement of financial position, often called the balance sheet, is a financial statement that reports the assets, liabilities, and equity of a company on a given date. In other words, it lists the resources, obligations, and ownership details of a company on a specific day. You can think of this like a snapshot of what the company looked like at a certain time in history.

This definition is true in the sense that this statement is a historical report. It only shows the items that were present on the day of the report. This is in contrast with other financial reports like the income statement that presents company activities over a period of time. The statement of financial position only records the company account information on the last day of an accounting period.

In this sense, investors and creditors can go back in time to see what the financial position of a company was on a given date by looking at the balance sheet.

Example

Let’s take a look at a statement of financial position example.

Paul's Guitar Shop, Inc.
Statement of Financial Position
December 31, 20X6

Assets	
Current Assets	
Cash	32800
Inventory	39800
Total Current Assets	72600
Fixed Assets	
Leasehold Improvements	100000
Accumulated Depreciation	(2000)
Total Fixed Assets	98000
Other Assets	
Trademarks	20000
Accumulated Amortization	?
Total Other Assets	?
Total Assets	182600
Liabilities	
Current Liabilities	
Accounts Payable	49000
Accrued Expenses	?
Total Current Liabilities	?
Long-term Liabilities	25000
Total Liabilities	75000
Owner's Equity	
Owner's Equity	
Common Stock	20000
Retained Earnings	87600
Total Owner's Equity	107600
Total Liabilities and Owner's Equity	182600

As you can see from our example template, each balance sheet account is listed in the accounting equation order. This organization gives investors and creditors a clean and easy view of the company's resources, debts, and economic position that can be used for financial analysis purposes.

Investors use this information to compare the company's current performance with past performance to gauge the growth and health of the business. They also compare this information with other companies' reports to decide where the opportune place is to invest their money.

Creditors, on the other hand, are not typically concerned with comparing companies in the sense of investment decision-making. They are more concerned with the health of a business and the company's ability to pay its loan payments. Analyzing the leverage ratios, debt levels, and overall risk of the company gives creditors a good understanding of the risk involving in loaning a company money.

Obviously, internal management also uses the financial position statement to track and improve operations over time.

Now that we know what the purpose of this financial statement is, let's analyze how this report is formatted in a little more detail.

Format

The statement of financial position is formatted like the accounting equation (assets = liabilities + owner's equity). Thus, the assets are always listed first.

Assets

Assets are resources that the company can use to create goods or provide services and generate revenues. There are many ways to format the assets section, but the most common size balance sheet divides the assets into two sub-categories: current and non-current. The current assets include cash, accounts receivable, and inventory. These resources are typically consumed in the current period or within the next 12 months. The non-current assets section includes resources with useful lives of more than 12 months. In other words, these assets last longer than one year and can be used to benefit the company beyond the current period. The most common non-current assets include property, plant, and equipment.

Liabilities

Liabilities are debt obligations that the company owes other companies, individuals, or institutions. These range from commercial loans, personal loans, or mortgages. This section is typically split into two main sub-categories to show the difference between obligations that are due in the next 12 months, current liabilities, and obligations that mature in future years, long-term liabilities. Current debt usually includes accounts payable and accrued expenses. Both of these types of debts typically become due in less than 12 months. The long-term section includes all other debts that mature more than a year into the future like mortgages and long-term notes.

Equity

Equity consists of the ownership of the company. In other words, this measures their stake in the company and how much the shareholders or partners actually own. This section is displayed slightly different depending on the type of entity. For example a corporation would list the common stock, preferred stock, additional paid-in capital, treasury stock, and retained earnings. Meanwhile, a partnership would simply list the members' capital account balances including the current earnings, contributions, and distributions.

In the world of nonprofit accounting, this section of the statement of financial position is called the net assets section because it shows the assets that the organization actually owns after all the debts have been paid off. It's easier to understand this concept by going back to an accounting equation example. If we rearrange the accounting equation to state equity = assets – liabilities, we can see that the equity of a non-profit is equal to the assets less any outstanding liabilities.

2. Does the Balance Sheet always balance?

Notice that the balance sheet is always in balance. Just like the accounting equation, the assets must always equal the sum of the liabilities and owner's equity. This makes sense when you think about it because the company has only three ways of acquiring new assets.

It can use an asset to purchase and a new one (spend cash for something else). It can also take out a loan for a new purchase (take out a mortgage to purchase a building). Lastly, it can take money from the owners for a purchase (sell stock to raise cash for an expansion). All three of these business events follow the accounting equation and the double entry accounting system where both sides of the equation are always in balance.

3. Why the balance sheet always balances?

The balance sheet is structured in a manner that the total assets of an entity equal to the sum of liabilities and equity. This may lead you to wonder as to why the balance sheet must always be in equilibrium.

Assets of an entity may be financed from internal sources (i.e. share capital and profits) or from external credit (e.g. bank loan, trade creditors, etc.). Since the total assets of a business must be equal to the amount of capital invested by the owners (i.e. in the form of share capital and profits not withdrawn) and any borrowings, the total assets of a business must equal to the sum of equity and liabilities.

This leads us to the Accounting Equation: Assets = Liabilities + Equity

4. Purpose & Importance

Statement of financial position helps users of financial statements to assess the financial health of an entity. When analyzed over several accounting periods, balance sheets may assist in identifying underlying trends in the financial position of the entity. It is particularly helpful in determining the state of the entity's liquidity risk, financial risk, credit risk and business risk. When used in conjunction with other financial statements of the entity and the financial statements of its competitors, balance sheet may help to identify relationships and trends which are indicative of potential problems or areas for further improvement. Analysis of the statement of financial position could therefore assist the users of financial statements to predict the amount, timing and volatility of entity's future earnings.

The Format of the Balance Sheet:

Assets:	**Liabilities:**
Current:	Current:
Cash	Accounts Payable
Accounts Receivable	Accrued Expenses (Liabilities)
Inventory	Unearned Revenues
Prepaid Expenses	"_______" Payables
Short-term Investments	Income Taxes Payable
Short-term Notes Receivable	Short-term Notes Payable
Supplies	Current Portion of Long-term Debt
Total Current Assets	**Total Current Liabilities**
Long-term Investments	Bonds Payable
Long-term Notes Receivable	Long-term Debt
Property/Plant/Equipment (P/P/E):	Long term Notes Payable
Land	**Total Liabilities**
Building	
Equipment	**Stockholder's Equity:**
Less Accumulated Depreciation	Common Stock

Net P/P/E	Additional Paid in Capital
Intangible Assets	Retained Earnings
Goodwill	less Treasury Stock
Patents, net	**Total Stockholder's Equity**
Trademarks, net	
Copyrights, net	
Total Intangible Assets	
Other Assets	
Total Assets must =	Total Liabilities & Stockholder's Equity

Example – presentation of a statement of financial position

Ex 1 A group prepares its consolidated financial statements in accordance with the *IFRS*. The group's consolidated statement of financial position is set out below.

<u>Prepare the Statement of Financial Position under the following information</u>

A Group's consolidated statement of financial position at 31 December 20XX (in currency units)

	31 December 20X7
ASSETS	
Current assets:	
Total current assets	
Non-current assets:	
Total non-current assets	
Total assets	**1,466,500**
LIABILITIES AND EQUITY	
Current liabilities:	

Total current liabilities	
Non-current liabilities:	
Total non-current liabilities	
Total liabilities	**492,750**
Equity:	
Total equity attributable to owners of the parent	
Non-controlling interests	
Total equity	
Total equity and liabilities	

	31 December 20X7
Investment property—carried at fair value	150,000
Long-term employee benefit obligations	78,000
Cash and cash equivalents	312,400
Trade receivables	91,600
Current portion of obligations under finance leases	1,500
Trade and other payables	90,100
Other financial assets—derivative hedging instruments	2,000
Retained earnings	243,500
Property, plant and equipment—carried at cost less accumulated depreciation	200,700
Inventories	135,230
Other current assets	23,650
Share capital	650,000
Other intangible assets	107,070
Actuarial gains on defined benefit pension plan	8,200
Financial assets—investments in shares	100,150
Investments in associates:	100,500
– carried at fair value	60,000
– carried at cost less impairment	40,500
Investments in jointly controlled entities:	42,000
– carried at fair value	20,000
– carried at cost less impairment	22,000
Bank loans	65,000

Short-term borrowings	150,000
Biological assets	70,000
– carried at fair value	30,000
– carried at cost less impairment	40,000
Bank overdrafts	10,000
Goodwill	80,800
Current tax payable	23,500
Deferred tax assets	50,400
Current portion of bank loans	20,000
Current portion of employee benefit obligations	15,000
Non-controlling interests	70,050
Short-term provisions	5,000
Obligations under finance leases	2,300
Environmental restoration provision	26,550
Deferred tax liabilities	5,800
Gains on hedges of foreign exchange risks of firm commitments	2,000

Example – current/non-current distinction

Ex 2 The entity in example 1 presents current and non-current assets and current and non-current liabilities separately. The entity in this example presents assets and liabilities in order of approximate liquidity.

<u>Prepare the Statement of Financial Position under the following information</u>

An entity's statement of financial position at 31 December 20X8

(in thousands of currency units)

	31 December 20X7
ASSETS:	
Total assets	
Liabilities:	
Total liabilities	
Shareholders' equity:	
Total shareholders' equity	

Total equity and liabilities	
	31 December 20X7
Interest payable	230
Cash and cash equivalents	230
Long-term debt	2,300
Trade receivables	1,900
Inventory	1,000
Retained earnings	3,230
Share capital	1,500
Portfolio investments cost	2,500
Property, plant and equipment:	
Property, plant and equipment: cost	3,730
Property, plant and equipment: accumulated depreciation	(1,450)
Income taxes payable	400
Trade payables	250

Prepare the Statement of Financial Position under the following information

	31 December 20XX
ASSETS	
Non-current assets	
Total non-current assets	
Current assets	
Total current assets	
Total assets	
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent:	
Total equity	
Non-current liabilities:	
Total non-current liabilities	
Current liabilities	

Total current liabilities	
Total liabilities	**3,564**
Total equity and liabilities	

	31 December 20XX
Warranty provision	400
Retained earnings	2,690
Property, plant and equipment	2,874
Trade and other receivables	1,700
Investment property	2,500
Long-term provisions (environmental restoration)	280
Share capital	1,500
Current portion of long-term debt	500
Inventory	1,180
Non-controlling interests	730
Cash and cash equivalents	230
Other short-term provisions	1
Long-term debt	1,800
Trade and other payables	253
Interest accrued on long-term debt	230
Dividends declared	100

5. Income Statement

The income statement, also called the profit and loss statement, is a report that shows the income, expenses, and resulting profits or losses of a company during a specific time period. The income statement is the first financial statement typically prepared during the accounting cycle because the net income or loss must be calculated and carried over to the statement of owner's equity before other financial statements can be prepared.

The income statement calculates the net income of a company by subtracting total expensesfrom total income. This calculation shows investors and creditors the overall profitability of the company as well as how efficiently the company is at generating profits from total revenues.

The income and expense accounts can also be subdivided to calculate gross profit and the income or loss from operations. These two calculations are best shown on a multi-step income statement. Gross profit is calculated by subtracting cost of goods sold from net sales. Operating income is calculated by subtracting operating expenses from the gross profit.

Unlike the balance sheet, the income statement calculates net income or loss over a range of time. For example annual statements use revenues and expenses over a 12-month period, while quarterly statements focus on revenues and expenses incurred during a 3-month period.

Format

There are two income statement formats that are generally prepared.

Single-step income statement – the single step statement only shows one category of income and one category of expenses. This format is less useful of external users because they can't calculate many efficiency and profitability ratios with this limited data.

Multi-step income statement - the multi-step statement separates expense accounts into more relevant and usable accounts based on their function. Cost of goods sold, operating and non-operating expenses are separated out and used to calculate gross profit, operating income, and net income.

In both income statement formats, revenues are always presented before expenses. Expenses can be listed alphabetically or by total dollar amount. Either presentation is acceptable.

Income statement expenses can also be formatted by the nature and the function of the expense.

All income statements have a heading that display's the company name, title of the statement and the time period of the report. For example, an annual income statement issued by Paul's Guitar Shop, Inc. would have the following heading:

- Paul’s Guitar Shop, Inc.
- Income Statement
- For the Year Ended December 31, 20X6

Example

Here is an example of how to prepare an income statement from Paul’s adjusted trial balance in our earlier accounting cycle examples.

Single Step Income Statement

Paul’s Guitar Shop, Inc.
Income Statement
For the Year Ended December 31, 20X6

Revenues	
Merchandise Sales	?
Music Lesson Income	3000
Total Revenues	?
Expenses	
Cost of Goods Sold	10200
Depreciation expense	2000
Wage expense	750
Rent expense	500
Interest expense	500
Supplies expense	500
Utilities expense	400
Total Expenses	14850
Net Income	12950

As you can see, this example income statement is a single-step statement because it only lists expenses in one main category. Although this statement might not be extremely useful for investors looking for detailed information, it does accurately calculate the net income for the year.

This net income calculation can be transferred to Paul's statement of owner's equity for preparation.

Multi Step Income Statement

A simple multiple step income statement separates income, expenses, gains, and losses into two meaningful sub-categories called operating and non-operating. Unlike the single step income statement format where all revenues are combined in one main income listing and all expenses are totaled together, the multiple step statement lists these activities in separate sections, so users can better understand of the core business operations.

This is particularly helpful for analyzing the performance of the business. Investors and creditors can evaluate how well a company performs its main functions separate from any other activities the business is involved in. For instance, a retailer's main function is to sell merchandise. Investors and creditors want to know how efficiently the retailer sells its merchandise without diluting the numbers with other gains and losses from non-merchandise related sales.

To do this, all income and expenses cannot be listed together. They must be separated into meaningful categories.

Format

The multistep income statement format is broken down into two main sections: operating and non-operating.

Operating Section

The operating section is subdivided into two main sections that list the primary business income and expenses. The first section computes the gross profit of the business by subtracting the cost of goods sold from the total sales. This is a key figure for investors, creditors, and internal management because it shows how profitable the company is at selling its goods or making its products.

Jazz Music Shop, Inc.
Income Statement
For the Year Ended December 31, 20X6

Sales	6400
Cost of Goods Sold	1400
Gross Profit	5000

Going back to our retailer example, the total sales figure would include all merchandise sales made during the period and the cost of goods sold would include all expenses paid to purchase, ship, and get the merchandise ready for sale. The gross margin computes the amount of money the company profits from the sales of its merchandise. Keep in mind, no other expenses are taken into account yet. This is simply the cash flow in from the sales of merchandise and the cash flow out from the purchase of that merchandise. This section not only helps measure the profitability of the core business activities, it also helps measure the health of the business.

The second part of the operating section lists all of the operating expenses in two separate categories: selling and administrative. Selling expenses are exactly what they sound like: costs incurred to sell products. These expenditures typically include advertising, salesmen salaries, commissions, and freight. The administrative expenses include expenditures that aren't directly related to selling product like rent, office staff salaries, and supplies.

The selling and administrative expense sections are added together to compute the total operating expenses. This total expense line is subtracted from the gross profit computed in the first section to arrive at the company's operating income.

Operating Expenses	
Selling expense	334
Advertising expense	100
Sales commissions	234
Administrative expenses	981
Rent expense	950
Supplies expense	31
Total Operating Expenses	1315
Income From Operations	3685

Non-Operating and Other

The non-operating and other section lists all business revenues and expenses that don't relate to the business' principle activities. For example, our retailer isn't in the business of receiving insurance proceeds. If a tree hit the building and the insurance company paid out a small settlement, the income would not be reported with total sales. It would be reported in the non-operating and other section because it doesn't have anything to do with sales.

Non-Operating Income and Expenses	
Insurance proceeds	1000
Interest expense	250
Total Operating	750
Net Income	4435

Other income and expenses like interest, lawsuit settlements, extraordinary items, and gains or losses from investments are also listed in this section. Unlike the operating section, the non-operating section is not split into subcategories. It simply lists all of the activities and totals them at the bottom.

Once the non-operating section is totaled, it is subtracted from or added to the income from operations to compute the net income for the period.

Example

Let's take a look at a multi step income statement example.

Jazz Music Shop, Inc.
Income Statement
For the Year Ended December 31, 20X6

Sales	6400
Cost of Goods Sold	1400
Gross Profit	5000
Operating Expenses	
Selling expense	334
Advertising expense	100

Sales commissions	234
Administrative expenses	981
Rent expense	950
Supplies expense	31
Total Operating Expenses	1315
Income From Operations	3685
Non-Operating Income and Expenses	
Insurance proceeds	1000
Interest expense	250
Total Operating	750
Net Income	4435

As you can see, this multi step income statement template computes net income in three steps.

Step 1: Compute Gross Profit (Total sales – Cost of goods sold)

Step 2: Compute Income From Operations (Gross profit – operating expenses)

Step 3: Compute Net Income (Income from operations – non-operating and other)

The cost of goods sold is separated from the operating expenses and listed in the gross margin section. This is particularly important because it gives investors, creditors, and management the ability to analyze the financial statement sales and purchasing efficiency.

The operating section clearly lists the operating income of the company. This is the amount of money the company made from selling its products after all operating expenses have been paid. This is a key figure because it shows the health of the business. If a company's operations are strong, it will almost always show a profit at the bottom line, but not all companies with a profitable bottom line have strong operations. Take our retailer for example. It might have lost money from its operations but had a huge insurance settlement that pushed a profit to the bottom line. Is this business healthy? Probably not. That's why this section is so important.

Lastly, you can see the non-operating and other section being subtracted to compute the net income.

The multistep income statement gives far more detail than the single step statement, but it can also be more misleading if not prepared correctly. For instance, management might shift expenses out of cost of goods sold and into operations to artificially improve their margins. It's always important to view comparative financial statements over time, so you can see trends and possibly catch misleading placement of expenses.

During 20X7, after the entity's 20X6 financial statements were approved for issue, the entity discovered a computational error in the calculation of depreciation expense for the year ended 31 December 20X6 (ie profit before tax for the year ended 31 December 20X6 is overstated by CU7,800, with a resultant CU1,950 overstatement of income tax expense).

The entity's statement of comprehensive income for the year ended 31 December 20X7 could be presented as follows:

An entity – statement of comprehensive income for the year ended 31 December 20X7

	31 December 20XX
Revenue	?
Other income	54,000
Changes in inventories of finished goods and work in progress	23,520
Raw material and consumables used	(428,000)
Employee benefits expense	(78,000)
Depreciation and amortisation expense	(25,600)
Impairment of property, plant and equipment	–
Other expenses	(4,500)
Finance costs	(22,300)
Share of profit of associates	42,100
Profit before tax	**241,220**
Income tax expense	(60,305)
Profit/Total comprehensive income for the year	**180,915**

The statement of comprehensive income of an entity could be presented in a single statement as follows:

An entity's statement of comprehensive income for the year ended 31 December 20XX

	31 December 20XX
Revenue	645,000
Cost of sales	(500,000)
Distribution costs	?
Administrative expenses	(30,000)
Finance costs	(10,000)
Profit before tax	**55,000**
Income tax expense	(13,750)
Profit for the year	**41,250**
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Change in the fair value of hedging instruments, net of tax	(3,800)
Reclassified losses on hedging instrument to profit or loss	(720)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**46,990**

A group (a parent and its wholly-owned subsidiary) that follows a single-statement approach to present its financial performance could prepare its statement of comprehensive income as follows:

A group's statement of comprehensive income for the year ended 31 December 20XX

	31 December 20XX
Revenue	680,000
Cost of sales	(400,000)
Distribution costs	(8,580)
Administrative expenses	(50,000)
Finance costs	?
Share of profit of associates	42,100
Profit before tax	**241,220**
Income tax expense	(60,305)
Profit for the year from continuing operations	**180,915**
Loss for the year from discontinued operations	(24,780)
Profit for the year	**156,135**
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Actuarial gains on defined benefit pension obligations, net of tax	(720)
Share of associates' other comprehensive income	(3,800)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**161,875**

The group could prepare its separate income statement and separate statement of comprehensive income as follows:

A group's consolidated income statement for the year ended 31 December 20XX	
	31 December 20XX
Revenue	680,000
Cost of sales	(400,000)
Distribution costs	(8,580)
Administrative expenses	(50,000)
Finance costs	(22,300)
Share of profit of associates	42,100
Profit before tax	241,220
Income tax expense	(60,305)
Profit for the year from continuing operations	**180,915**
Loss for the year from discontinued operations	(24,780)
PROFIT FOR THE YEAR	**?**
Profit for the year is attributable to:	

Owners of the parent	151,135
Non-controlling interests	5,000
	156,135
A Group – consolidated statement of comprehensive income for the year ended 31 December 20XX	
Profit for the year	156,135
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Actuarial gains on defined benefit pension obligations, net of tax	(720)
Share of associates other comprehensive income	(3,800)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**161,875**
Total comprehensive income for the year is attributable to:	
Owners of the parent	156,575
Non-controlling interests	5,300
	161,875

Example – additional line items, headings and subtotals

Ex 10 A retailer may present additional line items (eg gross profit, profit before tax and profit from continuing operations) in its consolidated statement of comprehensive income because the group's management believes that such presentation is relevant to an understanding of the entity's financial performance.

An entity's statement of comprehensive income for the year ended 31 December 20XX	
	31 December 20XX
Revenue	680,000
Cost of sales	(400,000)
Gross profit	**?**
Distribution costs	(8,580)
Administrative expenses	(50,000)
Finance costs	(22,300)
Share of profit of associates	42,100
Profit before tax	**?**
Income tax expense	(60,305)
Profit for the year from continuing operations	**180,915**
Loss for the year from discontinued operations	(24,780)
Profit for the year	**156,135**
Other comprehensive income:	
Exchange differences on translating foreign operations, net	10,260

of tax	
Actuarial gains on defined benefit pension obligations, net of tax	(720)
Share of associates other comprehensive income	(3,800)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**161,875**

A group (a parent and its wholly-owned subsidiary) that presents its financial performance using the single-statement approach and presents an analysis by nature of expenses in its statement of comprehensive income could present its statement of comprehensive income as follows:

A group's consolidated statement of comprehensive income for the year ended 31 December 20X

	31 December 20XX
Revenue	734,000
Gain in the fair value of investment property	1,000
Changes in inventories of finished goods and work in progress	(26,480)
Raw material and consumables used	(378,000)
Employee benefits expense	(78,000)
Depreciation and amortisation expense	(25,600)
Impairment of property, plant and equipment	–
Advertising costs	(3,000)
Raw material freight costs	(2,000)
Operating lease expense	?
Finance costs	(22,300)
Share of associate's losses	(100)
Profit before tax	**199,120**
Income tax expense	(49,780)
Profit for the year from continuing operations	**149,340**
Loss for the year from discontinued operations	(24,780)
PROFIT FOR THE YEAR	**124,560**
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Actuarial losses on defined benefit pension plans, net of tax	(720)
Change in the fair value of hedging instruments, net of tax	(3,800)
Reclassified gains (losses) on hedging instruments to profit or loss	1,560
Other comprehensive income for the year, net of tax	**7,300**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**131,860**

6. Cash Flow Statement

The statement of cash flows, also called the cash flow statement, is the fourth general-purpose financial statement and summarizes how changes in balance sheet accounts affect the cash account during the accounting period. It also reconciles beginning and ending cash and cash equivalents account balances.

This statement shows investors and creditors what transactions affected the cash accounts and how effectively and efficiently a company can use its cash to finance its operations and expansions. This is particularly important because investors want to know the company is financially sound while creditors want to know the company is liquid enough to pay its bills as they come due. In other words, does the company have good cash flow?

The term cash flow generally refers to a company's ability to collect and maintain adequate amounts of cash to pay its upcoming bills. In other words, a company with good cash flow can collect enough cash to pay for its operations and fund its debt service without making late payments.

Format and Template

The cash flow statement format is divided into three main sections: cash flows from operating activities, investing activities, and financing activities.

Operating Activities

Cash flows from operating activities include transactions from the operations of the business. In other words, the operating section represent the cash collected from the primary revenue generating activities of the business like sales and service income. Operating activities are short-term and only affect the current period. For example, payment of supplies is an operating activity because it relates to the company operations and is expected to be used in the current period.

Operating cash flows are calculated by adjusting net income by the changes in current asset and liability accounts.

Investing Activities

Cash flows from investing activities consist of cash inflows and outflows from sales and purchases of long-term assets. In other words, the investing section of the statement represents the cash that the company either collected from the sale of a long-term asset or the amount of money spent on purchasing a new long-term asset. You can think of this section as the company investing in itself. The investments are long-term in nature and expected to last more than one accounting period.

Investing cash flows are calculated by adding up the changes in long-term asset accounts.

Financing Activities

Cash flows from financing consists of cash transactions that affect the long-term liabilities and equity accounts. In other words, the financing section on the statement represents the amount of cash collected from issuing stock or taking out loans and the amount of cash disbursed to pay dividends and long-term debt. You can think of financing activities as the ways a company finances its operations either through long-term debt or equity financing.

Financing cash flows are calculated by adding up the changes in all the long-term liability and equity accounts.

Here's a tip!

Here is a tip on how I keep track of what transactions go in each cash flow section.

Operating Activities: includes all activities that are reported on the income statement under operating income or expenses.

Investing Activities: includes all cash transactions used to buy or sell long-term assets. Think of these as the company investing in itself.

Financing Activities: includes all cash transactions that affect long-term liabilities and equity. Whenever long-term debt or equity is involved, it is considered a financing activity.

Like all financial statements, the statement of cash flows has a heading that display's the company name, title of the statement and the time period of the report. For example, an annual income statement issued by Paul's Guitar Shop, Inc. would have the following heading:

- Paul's Guitar Shop, Inc.
- Cash Flow Statement
- December 31, 20X5

Example

Here is the statement of cash flows example from our unadjusted trial balance and financial statements used in the accounting cycle examples for Paul's Guitar Shop.

Paul’s Guitar Shop, Inc.
Statement of Cash Flows
For the Year Ended December 31, 20X6

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	12950
Adjustments to reconcile net income to	
net cash provided by operating activities:	
Depreciation on fixed assets	2000
(Increase) decrese in current assets:	
Accounts receivable	(300)
Inventory	(39800)
Prepaid expenses	(1000)
Increase (decrese) in current liabilities:	
Accounts payable	49000
Accrued expenses and unearned revenues	1450
NET CASH PROVIDED BY OPERATING ACTIVITIES	24300
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of property and equipment	(101000)
NET CASH USED IN INVESTING ACTIVITIES	(101000)
CASH FLOWS FROM FINANCING ACTIVITIES	

Proceeds from line of credit	-
Payments on line of credit	10000
Proceeds from long-term debt	99500
Payments on long-term debt	-
NET CASH PROVIDED (USED) FINANCING ACTIVITIES	109500
NET INCREASE (DECRESE) IN CASH	32800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	32800

Preparation

The statement of cash flows is generally prepared using two different methods: the direct method and the indirect method. Both result in the same financial statement showing how financial transacations affected would have affected the bank account of the company. Each method is used for a slightly different reason and typically used for different sized companies. Let's take a look at how to create a statement using both the direct and the indirect methods in the next aritcles.

Statement of Cash Flows Direct Method

The cash flow statement presented using the direct method is easy to read because it lists all of the major operating cash receipts and payments during the period by source. In other words, it lists where the cash inflows came from, usually customers, and where the cash outflows went, typically employees, vendors, etc.

After all of the sources are listed, the total cash payments are then subtracted from the cash receipts to compute the net cash flow from operating activities. Then the investing and financing activities added to arrive at the net cash increase or decrease. Let’s take a look at how this report is formatted and structured.

Format

Here’s a list of the most common types of receipts and payments used in the direct method format:

- Receipts received from Customers
- Payments paid to Suppliers
- Payments paid to Employees
- Interest Payments
- Income Tax Payments

As you can see, listing these payments gives the financial statement user a great deal of information where receipts are coming from and where payments are going to. This is one of the main advantages of the direct method compared with the indirect method. Investors, creditors, and management can actually see where the company is collecting funds from and whom it is paying funds to. The indirect method doesn’t list these types of details. That’s exactly why FASB recommends that all companies issue their statement of cash flows in the direct method.

The problem with this method is it’s difficult and time consuming to create.

Most companies don't record and store accounting and transactional information by customer, supplier, or vendor. Business events are recorded with income statement and balance sheet accounts like sales, materials, and inventory. It's laborious for most companies to compile the information with this method.

For example, in order to figure out the receipts and payments from each source, you have to use a unique formula. The receipts from customers equals net sales for the period plus the beginning accounts receivable less the ending accounts receivable. Similarly the payments made to suppliers is calculated by adding the purchases, ending inventory, and beginning accounts payable then subtracting the beginning inventory and ending accounts payable.

Keep in mind that these formulas only work if accounts receivable is only used for credit sales and accounts payable is only used for credit account purchases. This is why most companies don't issue this method. It's difficult to gather the information.

Plus, the direct method also requires a reconciliation report be created to check the accuracy of the operating activities. The reconciliation itself is very similar to the indirect method of reporting operating activities. It stars with net income and adjusts non-cash transaction like depreciation and changes in balance sheet accounts. Since creating this reconciliation is about as much work as just preparing an indirect statement, most companies simply choose not to use the direct method.

I know what you are probably thinking. If you have to do an additional reconciliation, why is it called the direct method. It seems like a whole like more work. Well, it is. The reason why it's called that has nothing to do with how much work is involved in preparing the report. It has to do with how the operating cash flows are derived. This method looks directly at the source of the cash flows and reports it on the statement. The indirect method, on the other hand, computes the operating cash flows by adjusting the current year's net income for changes in balance sheet accounts.

This is the only difference between the direct and indirect methods. The investing and financing activities are reported exactly the same on both reports.

Let's look at an example.

Example

Here's an example of a cash flow statement prepared using the direct method.

Paul's Guitar Shop, Inc.
Statement of Cash Flows
For the Year Ended December 31, 20X6

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from customers	51300
Cash paid for merchandise	(15000)
Cash paid to employees	(10000)
Cash paid for interest	(500)
Cash paid for income taxes	(1500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	24300

CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of property and equipment	(101000)
NET CASH USED IN INVESTING ACTIVITIES	(101000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from line of credit	-
Payments on line of credit	10000
Proceeds from long-term debt	99500
Payments on long-term debt	-
NET CASH PROVIDED (USED) FINANCING ACTIVITIES	109500
NET INCREASE (DECRESE) IN CASH	32800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	32800

As you can see, all of the operating activities are clearly listed by their sources. This categorization does make it useful to read, but the costs of producing it for outweigh the benefits to the external users. This is why FASB has never made it a requirement to issue statements using this method.

Statement of Cash Flows Indirect Method

The statement of cash flows prepared using the indirect method adjusts net income for the changes in balance sheet accounts to calculate the cash from operating activities. In other words, changes in asset and liability accounts that affect cash balances throughout the year are added to or subtracted from net income at the end of the period to arrive at the operating cash flow.

The operating activities section is the only difference between the direct and indirect methods. The direct method lists all receipts and payments of cash from individual sources to compute operating cash flows. This is not only difficult to create; it also requires a completely separate reconciliation that looks very similar to the indirect method to prove the operating activities section is accurate.

Companies tend to prefer the indirect presentation to the direct method because the information needed to create this report is readily available in any accounting system. In fact, you don't even need to go into the bookkeeping software to create this report. All you need is a comparative income statement. Let's take a look at the format and how to prepare an indirect method cash flow statement.

Format

The indirect operating activities section always starts out with the net income for the period followed by non-cash expenses, gains, and losses that need to be added back to or subtracted from net income. These non-cash activities typically include:

- Depreciation expense
- Amortization expense
- Depletion expense
- Gains or Losses from sale of assets
- Losses from accounts receivable

The non-cash expenses and losses must be added back in and the gains must be subtracted.

The next section of the operating activities adjusts net income for the changes in asset accounts that affected cash. These accounts typically include:

- Accounts receivable
- Inventory
- Prepaid expenses
- Receivables from employees and owners

This is where preparing the indirect method can get a little confusing. You need to think about how changes in these accounts affect cash in order to identify what way income needs to be adjusted. When an asset increases during the year, cash must have been used to purchase the new asset. Thus, a net increase in an asset account actually decreased cash, so we need to subtract this increase from the net income. The opposite is true about decreases. If an asset account decreases, we will need to add this amount back into the income. Here's a general rule of thumb when preparing an indirect cash flow statement:

Asset account increases: subtract amount from income

Asset account decreases: add amount to income

The last section of the operating activities adjusts net income for changes in liability accounts affected by cash during the year. Here are some of the accounts that usually are used:

- Accounts payable
- Accrued expenses

Get ready. If you weren't confused by the assets part, you might be for the liabilities section. Since liabilities have a credit balance instead of a debit balance like asset accounts, the liabilities section works the opposite of the assets section. In other words, an increase in a liability needs to be added back into income. This makes sense. Take accounts payable for example. If accounts payable increased during the year, it means we purchased something without using cash. Thus, this amount should be added back. Here's a basic tip that you can use for all liability accounts:

Liability account increases: add amount from income

Liability account decreases: subtract amount to income

All of these adjustments are totaled to adjust the net income for the period to match the cash provided by operating activities.

Example

It might be helpful to look at an example of what the indirect method actually looks like.

Paul’s Guitar Shop, Inc.
Statement of Cash Flows
For the Year Ended December 31, 20X6

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	12950
Adjustments to reconcile net income to	
net cash provided by operating activities:	
Depreciation on fixed assets	2000
(Increase) decrese in current assets:	
Accounts receivable	(300)
Inventory	(39800)
Prepaid expenses	(1000)
Increase (decrese) in current liabilities:	
Accounts payable	49000
Accrued expenses and unearned revenues	1450
NET CASH PROVIDED BY OPERATING ACTIVITIES	24300
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of property and equipment	(101000)
NET CASH USED IN INVESTING ACTIVITIES	(101000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from line of credit	-
Payments on line of credit	10000
Proceeds from long-term debt	99500
Payments on long-term debt	-
NET CASH PROVIDED (USED) FINANCING ACTIVITIES	109500
NET INCREASE (DECRESE) IN CASH	32800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	32800

As you can see, the operating section always lists net income first followed by the adjustments for expenses, gains, losses, asset accounts, and liability accounts respectively.

Although most standard setting bodies prefer the direct method, companies use the indirect method almost exclusively. It’s easier to prepare, less costly to report, and less time consuming to create than the direct method. Standard setting bodies prefer the direct because it provides more information for the external users, but companies don’t like it because it requires an additional reconciliation be included in the report. Since the indirect method acts as a reconciliation itself, it’s far less work for companies to simply prepare this report instead.

Financial effects of the entity's operations for the year ended 31 December 20X3:

	(Income) or Expense	Cash	Trade receivables	Trade payables	Accrued employee benefits	Inventory	Investment property	Furniture and equipment
Carrying amount at 01/01/20X3		600	200	(150)	(60)	1,000	800	500
Credit sales	(6,000)		6,000					
Credit purchases				(2,200)		2,200		
Cost of goods sold	3,000					(3,000)		
Cash receipts from customers		3,600	(3,600)					
Rental income	(40)	40						
Cash payments to suppliers		(2,000)		2,000				
Cash payments to employees	1,500	(1,560)			60			
Depreciation	50							(50)
Sale of computer	(110)	210						(100)
Change in fair value	(100)						100	
Profit/carrying amount at 31/12/20X3	(1,700)	890	2,600	(350)	–	200	900	350

Part A: Prepare the entity's statement of cash flows for the year ended 31 December 20X3 using the indirect method.

Part B: Prepare the entity's statement of cash flows for the year ended 31 December 20X3 using the direct method.

Part A: indirect method of presenting operating cash flows

Extract from the statement of cash flows of the entity for the year ended 31 December 20X3

Cash flows from operating activities	
Profit for the year	
Adjustments for non-cash income and expenses:	
Depreciation expense	
Increase in fair value of investment property	
Adjustment for item included in investing activities:	
Profit on sale of equipment	
Changes in working capital:	
Increase in trade and other receivables	
Decrease in inventories	
Increase in trade and other payables	

Net cash from operating activities	
Cash flows from investing activities	
Proceeds on sale of equipment	
Net cash from investing activities	
Cash and cash equivalents	
Increase in cash for the year ended 31 December 20X3	
Cash at 1 January 20X3	
Cash at 31 December 20X3	

Calculations that do not form part of the statement of cash flows presented above:

(a) CU2,600 closing balance less CU200 opening balance = CU2,400.

(b) CU200 closing balance less CU1,000 opening balance = CU800.

(c) CU350 closing balance less CU210 (ie 150 trade payables + CU60 accrued employee benefits)

opening balance = CU140.

(d) CU80 net cash flow from operating activities + CU210 net cash flow from investing activities

= CU290.

Part B: direct method of presenting operating cash flows

Entity X statement of cash flows for the year ended 31 December 20X3

Cash flows from operating activities	
Cash receipts from customers	
Rentals received from tenants	
Cash paid to suppliers and employees	
Net cash from operating activities	
Cash flows from investing activities	
Proceeds on sale of equipment	
Net cash from investing activities	
Cash and cash equivalents	
Increase in cash for the year ended 31 December 20X3	
Cash at 1 January 20X3	
Cash at 31 December 20X3	

7. A statement of changes in equity

A statement of changes in equity reflects all changes in equity between the beginning and the end of the reporting period arising from transactions with owners in their capacity as owners (ie owner changes in equity) reflecting the increase or decrease in net assets in the period. This statement provides a linkage between the entity's statement of financial position and its statement of comprehensive income.

The statement of changes in equity presents the user with information about each component of equity, including:

- a reconciliation between the carrying amount at the beginning and the end of the period of each component of equity;
- the effects of retrospective application of accounting policies; and
- the effects of retrospective restatement of prior period errors.

The consolidated statement of changes in equity (of a group that includes one or more partly-owned subsidiaries) also provides information about the share of equity attributable to the owners of the parent and that attributable to the non-controlling interests and information about changes in such interests.

A group's statement of changes in equity for the year ended 31 December 20XX (in currency units)

	Share capital	Share premium	Retained earnings	Total equity (attributable to owners of the parent)
Balance at 1 Jan 20X3	2,500,000	1,900,000	2,150,000	6,550,000
Correction of prior period error	–	–	(230,000)	(230,000)
Restated balance at 1 Jan 20X3	2,500,000	1,900,000	1,920,000	6,320,000
Changes in equity for 20X3				
Total comprehensive income for the year	–	–	567,100	567,100
Profit for the year	–	–	507,000	507,000
Actuarial losses on defined benefit plans for the year, net of tax	–	–	(6,900)	(6,900)
Gain on translation of foreign operation, net of tax	–	–	67,000	67,000
Dividends	–	–	(220,000)	(220,000)
Balance at 31 Dec 20X3	2,500,000	1,900,000	2,267,100	6,667,100
Changes in equity for 20X4				
Total comprehensive income for the year	–	–	619,100	619,100
Profit for the year (e)	–	–	667,300	667,300
Actuarial losses on defined benefit plans for the year, net of tax	–	–	(2,000)	(2,000)
Loss on translation of foreign operation, net of tax	–	–	(46,200)	(46,200)
Issue of Shares	1,000,000	5,000,000	–	6,000,000
Dividends	–	–	(320,000)	(320,000)
Balance at 31 Dec 20X4	3,500,000	6,900,000	2,566,200	12,966,200

	Share capital	*Share premium*	*Retained earnings*	*Attributable to owners of the parent*	*Noncontrolling interest*	*Total equity*
Balance at 1 Jan 20X3	2,500,000	,900,000	12,130,000	6,530,000	22,500	6,552,500
Correction of prior period error	–	–	(30,000)	(30,000)	(10,000)	(40,000)
Restated balance at 1 Jan 20X3	2,500,000	1,900,000	2,100,000	6,500,000	12,500	6,512,500
Changes in equity for 20X3						
Total comprehensive income for the year	–	–	566,600	566,600	6,750	573,350
Profit for the year	–	–	505,250	505,250	8,000	513,250
Actuarial losses on defined benefit plans for the year, net of tax	–	–	(5,650)	(5,650)	(1,250)	(6,900)
Gain on translation of foreign operation, net of tax	–	–	67,000	67,000	–	67,000
Dividends	–	–	(220,000)	(220,000)	(6,250)	(226,250)
Balance at 31 Dec 20X3	2,500,000	1,900,000	2,446,600	6,846,600	13,000	6,859,600
Changes in equity for 20X4						
Total comprehensive income for the year	–	–	616,600	616,600	10,250	626,850
Profit for the year	–	–	665,050	665,050	10,000	675,050
Actuarial gains and (losses) on defined benefit plans for the year, net of tax	–	–	(2,250)	(2,250)	250	(2,000)
Loss on translation of foreign operation, net of tax	–	–	(46,200)	(46,200)	–	(46,200)
Issue of shares	1,000,000	5,000,000	–	6,000,000	–	6,000,000
Dividends	–	–	(320,000)	(320,000)	(7,750)	(327,750)
Sale of shares in subsidiary	–	–	25,700	25,700	9,300	35,000
Balance at 31 Dec 20X4	3,500,000	6,900,000	2,768,900	13,168,900	24,800	13,193,700

A group's consolidated statement of changes in equity for the year ended 31 December 20X7

(in thousands of currency units)

	Share capital	Retained earnings	Hedges of foreign currency risk in forecast transactions	Hedge of commodity price risk in forecast transactions	Attributable to owners of the parent	Noncontrolling interests	Total equity
Balance at 1 Jan 20X6	500,000	256,000	(4,000)	2,000	754,000	83,778	837,778
Correction of a prior period error	–	5,000	–	–	5,000	500	5,500
Changes in accounting policy	–	5,500	–	–	5,500	667	6,167
Restated balance at 1 Jan 20X6	500,000	266,500	(4,000)	2,000	764,500	84,945	849,445
Total Comprehensive income	–	64,000	2,600	(1,100)	65,500	7,111	72,611
Profit or loss	–	60,000	–	–	60,000	6,000	66,000
Translation of foreign operations	–	6,400	–	–	6,400	2,110	8,510
Actuarial losses—defined benefit plans	–	(2,400)	–	–	(2,400)	(999)	(3,399)
Changes in the fair value of the hedging instrument, net of tax	–	–	3,000	(2,000)	1,000	–	1,000
Reclassified to profit or loss	–	–	(400)	900	500	–	500
Transactions with owners							
Dividends	–	(8,000)	–	–	(8,000)	(889)	(8,889)
Restated balance at 31 Dec 20X6	500,000	322,500	(1,400)	900	822,000	91,167	913,167
Restated balance at 31 Dec 20X6	500,000	322,500	(1,400)	900	822,000	91,167	913,167
Total comprehensive income	–	101,100	800	(500)	101,400	11,233	112,633
Profit or loss	–	98,300	–	–	98,300	10,000	108,300
Translation of Foreign operations	–	3,200	–	–	3,200	1,333	4,533
Actuarial losses—	–	(400)	–	–	(400)	(100)	(500)

defined benefit plans							
Changes in the fair value of the hedging instrument, net of tax	–	–	1,000	(800)	200	–	200
Reclassified to profit or loss	–	–	(200)	300	100	–	100
Transactions with owners							
Issues of share capital	100,000	–	–	–	100,000	–	100,000
Dividends	–	(12,000)	–	–	(12,000)	(1,333)	(13,333)
Transactions Between owners							
Acquired shares in a subsidiary from the non-controlling interest	–	(3,000)	–	–	(3,000)	(5,000)	(8,000)
Balance at 31 Dec 20X7	600,000	408,600	(600)	400	1,008,400	96,067	1,104,467

Example - Change in Accounting Policy IAS 8

ABC LTD until now has valued inventory using LIFO method. However, following changes to IAS 2 *Inventories*, the use of LIFO method has been disallowed. Therefore, management of the company intends to use FIFO method for the valuation of the company's stock.

Following are extracts of ABC LTD's most recent financial statements before the application of FIFO method.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Current Assets		
Cash and Bank	6	4
Short Term Investments	5	8
Inventory	10	12
	21	24

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Cost of Sales		
Opening Inventory	12	8
Purchases	48	44

Closing Inventory	(10)	(12)
	50	40

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	40	30
Net Profit	30	20
Divident	(10)	(10)
Closing Reserve	60	40

Accounting Treatment

The switch from LIFO method to FIFO method represents a change in accounting policy which must be accounted for retrospectively in the financial statements. Therefore, the change must be applied as if the new accounting policy was always in place.

Consequently, entity shall adjust all comparative amounts presented in the financial statements affected by the change in accounting policy for each prior period presented.

Management estimates that the value of its inventory using FIFO method would be as follows:

	20X2, $M	**20X1, $M**	**20X0, $M**
Inventory	12	13	10

Management further believes that the valuation of inventory using FIFO method for periods prior to 20X0 would produce materially similar results.

The financial statement extracts of ABC LTD would appear as follows after the retrospective application of the change in accounting policy.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Current Assets		
Cash and Bank	6	4
Short Term Investments	5	8
Inventory	12	13
	23	25

The amount of inventory is adjusted for current period as well as the prior period.

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Cost of Sales		
Opening Inventory	13	10

Purchases	48	44
Closing Inventory	(12)	(13)
	49	41

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	40	31
Net Profit	31	19
Divident	(10)	(10)
Closing Reserve	61	40

Note that the change is applied to both current period and prior period comparative amounts presented (i.e. retrospectively). The estimated effect of the change in accounting policy relating to the prior periods that are not presented (i.e. before 20X1) is adjusted in the opening reserves of 20X1.

The nature of the change in accounting policy must be disclosed in the financial statements of ABC LTD.

The example is for illustration purpose only and is just a simplified view of how a change in accounting policy is accounted for. In practice, the effects of changes in accounting policy may be hard to determine. Transitional provisions for adoption of policies specified by new standards must also be considered when applying a change in accounting policy due to changes in the requirements of the reporting standards.

Example Changes in Accounting Estimates

ABC LTD has depreciated a machine over its expected useful life of 5 years. The cost of machine was $100,000 and annual depreciation charge was therefore $25,000. No residual value is expected at the end of the machine's useful life.

Three years later, the remaining useful life of the machine was estimated to be only 1 years.

ABC LTD should account for the change in estimate prospectively by allocating the net carrying amount of the asset over its remaining useful life. No adjustment is required to restate the depreciation charge in previous accounting periods.

Depreciation expense for the machine would therefore be as follows:

	Depreciation Expense	**Accumulated Depreciation**	**Working**
Year 1	20,000	20,000	(100,000/5)
Year 2	20,000	40,000	(80,000/4)
Year 4	30,000	100,000	(30,000/1)

Although expected useful life of the machine has reduced at the end of third year, depreciation expense recorded in previous years is not affected. Instead, the depreciation expense is increased accordingly in years 3 and 4.

Example - Correction of Prior Period Accounting Errors IAS 8

Management of ABC LTD, while preparing financial statements of the company for the period ended 31st December 20X2, noticed that they had failed to account for depreciation in last year's accounts in respect of an office building acquired in the preceding year.

Following are extracts of ABC LTD's most recent financial statements before the application of FIFO method.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Non Current Assets		
Cost	50	50
Accumulated Depreciation	(10)	(8)
	40	42

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Administration Expenses		
Depreciation	2	1

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	40	30
Net Profit	30	20
Divident	(10)	(10)
Closing Reserve	60	40

Accounting Treatment

The omission of depreciation of office building in the previous year's financial statements represents a **prior period accounting error** which must be accounted for **retrospectively** in the financial statements. Consequently, ABC LTD shall adjust all comparative amounts presented in the current period's financial statements affected by the accounting error.

Management estimates that depreciation charge for the year 20X1 was under booked by $1 million.

Financial statement extracts of ABC LTD would appear as follows after the retrospective correction of the prior period accounting error.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Non Current Assets		
Cost	50	50
Accumulated Depreciation	(11)	(9)
	39	41

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Administration Expenses		
Depreciation	2	2

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	39	30
Net Profit	30	19
Divident	(10)	(10)
Closing Reserve	59	39

Note that the correction of the error is applied to all prior period comparative amounts affected by the omission (i.e. retrospectively). Current year's profit is therefore unaffected by the correction of prior period error.

The nature of the correction of prior period error must be disclosed in the financial statements of ABC LTD.

2. Complete the following sentences

1) Financial Statements

1. The _______________ will report the total amount of a corporation's retained earnings.

2. The financial statement that reports the liabilities is sometimes known as the statement of _____________________________.

3. The balance sheet reports amounts at a __________ in time.

4. The amount of working ___________ can be calculated quickly from a classified balance sheet.

5. The income statement reports amounts for a __________ of time.

6. The amounts earned from a company's main activities. ___________

7. The costs that are matched with revenues. ___________

8. Sales minus the cost of goods sold equals ________ profit.

9. The financial statement that reports the change in cash and cash equivalents is the statement ____________________.

10. The income statement is often referred to as the __________________________________.

11. Bonds payable will be reported as a long-term _____________.

12. Financial statements are best prepared under the ___________ basis of accounting.

13. Paid-in capital is one section of _________________' equity

14. The current period's net income is part of the corporation's ____________ earnings reported on the balance sheet.

15. The costs expiring during the current accounting period. ___________

16. Prepaid expenses are reported as ________.

17. Customer deposits are reported as ______________.

18. The statement of cash flows explains the changes in cash and cash____________________ during the specified time interval.

19. The first section of the statement of cash flows is the __________________ activities.

20. The financial statement with a structure that is similar to the accounting equation is the ______________ ______________.

21. The financial statement that reports the portion of change in owner's equity resulting from revenues and expenses during a specified time interval is the _____________ ________________.

<u>2) Balance Sheet</u>

1. The amounts reported on the balance sheet are as of a _________ in time.

2. Resources. ________

3. Obligations. ________

4. Sales on account that have not yet been collected are accounts _________________.

5. Merchandise on hand. ________

6. The total depreciation since an asset was acquired is _______________ depreciation.

7. Amounts owed for goods and services received on account are accounts ___________.

8. A corporation's owner's equity is referred to as ___________________' equity.

9. The cumulative amount of a corporation's earnings less its cumulative dividends is ______________ earnings.

10. _________ stock is a corporation's own stock that it has purchased but has not retired.

11. The company that has paid insurance premiums in advance should report the *unexpired* cost in the account ___________ Insurance.

12. A small amount of cash available to make small outlays is known as the _________ cash fund.

13. Inventory is reported as a ___________ asset.

14. One section of stockholders' equity is paid-in or contributed _________.

15. The declaration of dividends will reduce the balance in __________ earnings.

16. Inventories are often reported at the lower of cost or __________.

17. Cash that is restricted for the construction of a plant asset is reported in the balance sheet section labeled as _________________.

18. Sometimes an ______________ will require that a plant asset be written down to an amount smaller than its carrying value.

19. Patents, trademarks, and goodwill are examples of ________________.

20. The accounts Allowance for Doubtful Accounts and Accumulated Depreciation are known as _____________ accounts.

3) Income Statement

1. Amounts earned through a company's main activities. __________

2. A retailer's revenues. __________

3. Costs used up in order to earn revenues. __________

4. The __________ basis of accounting is better than the cash basis for measuring profitability in a limited time period.

5. The expense associated with debt.

6. At the end of the accounting year, income statement accounts are ______________.

7. Sales minus the cost of goods sold is gross _________.

8. Selling, general and administrative expenses are referred to as _____________ expenses.

9. The heading of the income statement discloses the _________ of time covered.

10. An accounting year beginning on July 1 and ending on June 30 is referred to as a _________ year.

11. Earnings per share must be reported on the income statement when a corporation's stock is publicly ___________.

12. An increase in net assets from a peripheral activity. __________

13. On a multiple-step income statement, interest expense is reported as a ________________ or other expense.

14. An extraordinary item is both 1) ______________ in occurrence, and 2) unusual in nature.

15. If a corporation sells a plant asset for less than its ___________ value, the difference will be reported as a loss on the ______________.

16. The largest expense on a retailer's income statement is usually its _____ of goods sold.

17. Accrual accounting requires that expenses be __________ with revenues.

18. Changes in accounting ___________ such as depreciation are not viewed as errors.

19. The few gains or losses that are not included in net income will be reported as part of other _____________________ income.

IFRS 18 Presentation and Disclosure in Financial Statements was issued in 2024 and is mandatorily applicable for the period starting on or after ***1 January 2027***, with earlier application permitted.

IFRS 18 replaces the oldest standard [IAS 1 Presentation of Financial Statements] which will no longer applicable.

3. Read the articles and discuss

TOP 4 CHANGES IN PROFIT OR LOSS STATEMENT UNDER IFRS 18

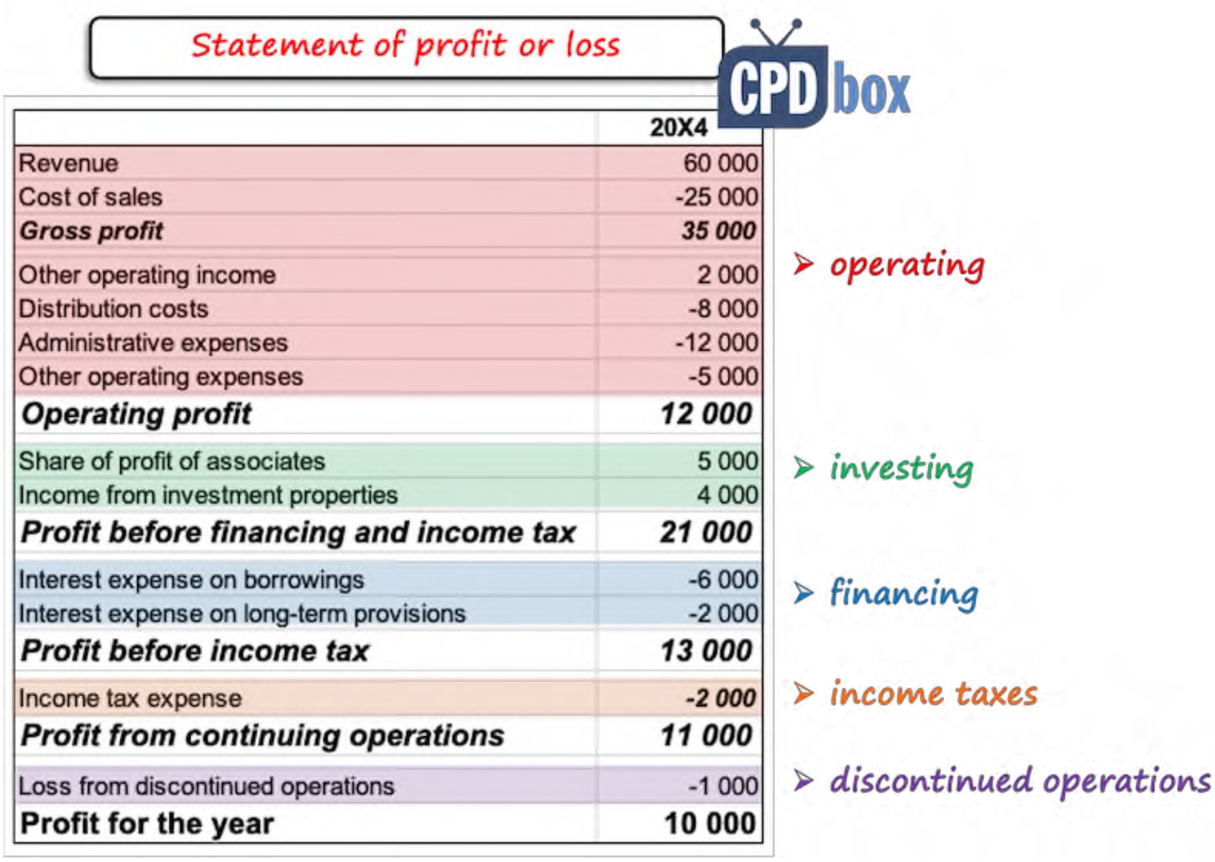
The new standard [IFRS 18] brought a few significant changes in the financial reporting, especially in profit or loss statement.

Let’s examine the top four of them and illustrate them on simple examples.

#1 New categories of income and expenses under IFRS 18

Under the new IFRS 18, we need to classify income and expenses in profit or loss into five categories (IFRS 18.47):

1. Operating;
2. Investing;
3. Financing;
4. Income tax;
5. Discontinued operations.



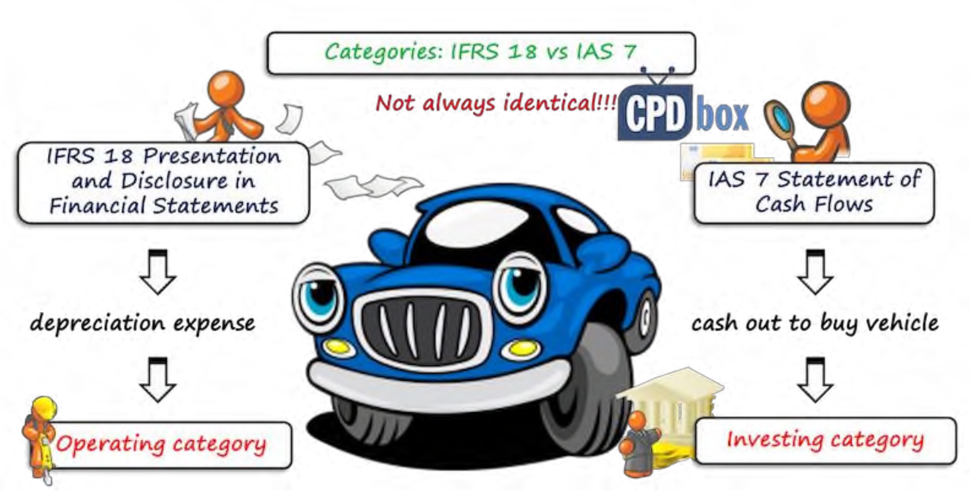
	20X4
Revenue	60 000
Cost of sales	-25 000
Gross profit	***35 000***
Other operating income	2 000
Distribution costs	-8 000
Administrative expenses	-12 000
Other operating expenses	-5 000
Operating profit	***12 000***
Share of profit of associates	5 000
Income from investment properties	4 000
Profit before financing and income tax	***21 000***
Interest expense on borrowings	-6 000
Interest expense on long-term provisions	-2 000
Profit before income tax	***13 000***
Income tax expense	*-2 000*
Profit from continuing operations	***11 000***
Loss from discontinued operations	-1 000
Profit for the year	**10 000**

Here I'd like to stress that ***the first three categories (operating, investing and financing)*** are indeed a new requirement.

While they might resemble the categories in statement of cash flows under IAS 7, they are NOT the same.

For example, imagine a company purchases the new machine to use in the production. Here's the difference:

- In the profit or loss statement under IFRS 18, the depreciation of that machine is classified in operating category;
- In the statement of cash flows under IAS 7, the expenditure (cash outflow) to purchase that machine is classified in investing category.



#2 New mandatory subtotals in profit or loss under IFRS 18

This is very logical requirement, because under older standard IAS 1, the companies presented subtotals as they liked, often making the financial statements ***incomparable*** between individual entities.

IFRS 18 requires presenting three subtotals (IFRS 18.69):

- ***Operating profit or loss***: here, all the items presented in operating category are included;
- ***Profit or loss before financing and income taxes***: this is the sum of operating category and investing category;
- ***Profit or loss***: the resulting profit or loss including all income and expenses.

The first two subtotals are new requirement.

Please note that there is no need to present the separate subtotal for investing category or financing category like in statements of cash flows.

Instead, the profit or loss is built up adding more and more line items to the operating profit or loss subtotal.

Subtotals in statement of profit or loss

	20X4
Revenue	60 000
Cost of sales	-25 000
Gross profit	***35 000***
Other operating income	2 000
Distribution costs	-8 000
Administrative expenses	-12 000
Other operating expenses	-5 000
Operating profit	***12 000***
Share of profit of associates	5 000
Income from investment properties	4 000
Profit before financing and income tax	***21 000***
Interest expense on borrowings	-6 000
Interest expense on long-term provisions	-2 000
Profit before income tax	***13 000***
Income tax expense	***-2 000***
Profit from continuing operations	***11 000***
Loss from discontinued operations	-1 000
Profit for the year	**10 000**

#3: Presentation of operating expenses by function, by nature or on a mixed basis

This requirement is not totally new, but IFRS 18 is making them more precise, explicitly permitting to present the mixed basis presentation.

The method of presentation is not the choice – ***IFRS 18 gives guidance*** on how to determine which presentation is most useful.

If you are presenting on "by-function" basis on the face of profit or loss statement, then you need to disclose also "by-nature" presentation in the notes (so effectively, you need to work out both methods).

Presentation of operating expenses

By nature / by function / mixed

	20X4
Revenue	60 000
Cost of sales	-25 000
Gross profit	***35 000***
Other operating income	2 000
Distribution costs	-8 000
Administrative expenses	-12 000
Other operating expenses	-5 000
Operating profit	***12 000***
Share of profit of associates	5 000
Income from investment properties	4 000
Profit before financing and income tax	***21 000***
Interest expense on borrowings	-6 000
Interest expense on long-term provisions	-2 000
Profit before income tax	***13 000***
Income tax expense	*-2 000*
Profit from continuing operations	***11 000***
Loss from discontinued operations	-1 000
Profit for the year	**10 000**

#4: Additional requirements for entities with specified main business activity

Prior we classify income and expenses into operating, investing or financing category, we must determine whether the entity has ***specified main business activity*** or not.

This is also logical, because the general format of profit or loss might not fit all the businesses.

More specifically, IFRS 18 sets additional requirements for two types of business activity:

1. ***Investing in assets***: for example, investment property companies, investment entities (e.g. funds), insurers;
2. ***Providing finance to customers***: for example, banks, lessors, manufacturer/dealer financing companies, etc.

If the company assesses that it indeed has one of these specified activities as its main business, it classifies certain items differently from other entities.

For example, interest expenses on loans:

- Manufacturing company without specified main business activities classifies interest expense in ***financing category***; but
- Bank providing loans to customers classifies interest expense in ***operating category***, especially when it is incurred on borrowings used to provide financing to customers.

Here's the comparison of the two statements of profit or loss:

Statement of profit or loss

Entities WITHOUT specified main business activity

	20X4
Revenue	60 000
Cost of sales	-25 000
Gross profit	***35 000***
Other operating income	2 000
Distribution costs	-8 000
Administrative expenses	-12 000
Other operating expenses	-5 000
Operating profit	***12 000***
Share of profit of associates	5 000
Income from investment properties	4 000
Profit before financing and income tax	***21 000***
Interest expense on borrowings	-6 000
Interest expense on long-term provisions	-2 000
Profit before income tax	***13 000***
Income tax expense	*-2 000*
Profit from continuing operations	***11 000***
Loss from discontinued operations	-1 000
Profit for the year	**10 000**

Entities WITH specified main business activity

	20X4
Interest income	623 500
Interest expense	-404 250
Net interest income	***219 250***
Fee and commission income	134 700
Fee and commission expense	-102 300
Net fee and commission income	***32 400***
Net trading income	4 200
Net investment income	8 400
Loss allowances on client loans	-67 800
Personnel expenses	-71 000
Depreciation and amortization	-13 000
Other operating expenses	-7 800
Operating profit	***137 050***
Share of profit of associates	19 800
Interest expenses on provisions	-24 800
Profit before income taxes	***132 050***
Income tax expense	-28 600
Profit for the year	**103 450**

How to Prepare Statement of Changes in Equity under IFRS 18

As the new IFRS 18 has been adopted, it might bring a bit of turmoil to some accountants who might need to change the structure of their accounts to adjust to the new requirements.

The good news is that the rules for the statement of changes in equity did not change, when compared to the older standard IAS 1 Presentation of Financial Statements.

Statement of changes in equity in line with IFRS 18

As a minimum, the statement of changes in equity must contain the following items:

- ***Total comprehensive income*** for the period, showing ***separately*** amounts attributable to ***owners of the parent*** and to ***non-controlling interests***.

If you are preparing the individual, or ***separate statement*** of changes in equity for a single entity, then the total comprehensive income will be fully attributable to the owners of that entity.

The split info the owners of the parent and non-controlling interests applies only in the ***consolidated financial statements*** for the group. Just to make it clear.

- ***The effect of retrospective application or restatement for each component of equity*** (if applicable).

So, if you corrected some material error in the equity, or applied some accounting policy retrospectively in line with IAS 8, then this effect is reported separately.

This is ***NOT seen as a change in equity***; rather this is seen as the ***restatement***, therefore it is secluded from the other parts.

- ***The reconciliation between the carrying amount at the beginning and the end of the period for each component of equity***.

Here, the following changes shall be disclosed separately:

  - those resulting from profit or loss
  - resulting from other comprehensive income
  - resulting from transactions with owners (contributions, distributions and changes in ownership).

The best way to do that is in the table format, showing individual components of equity in the columns, and individual transactions in rows.

Also, IFRS 18 prescribes to present ***amount of dividends*** recognized as distributions and the related amount per share on the face of the statement of changes in equity or in the notes.

Let's see the example.

Example: Statement of changes in equity

JBC Plc.'s balances on equity accounts were as follows:

Account	**31.12.20X4**	**31.12.20X3**	**1.1.20X3 restated**	**31.12.20X2**
Share capital	12 000	10 000	10 000	10 000
Share premium	1 300	1 100	1 100	1 100
Retained earnings	10 500	7 700	5 900	5 240
Revaluation surplus	1 380	1 580	1 000	1 000
Total equity	**25 180**	**20 380**	**18 000**	**17 340**

During 20X3, the following transactions occurred:

- ***Change in accounting policy*** resulting in restatement of retained earnings on 1 January 20X3 by 660 CU upwards;
- Payment of ***dividends*** to JBC's shareholders of 3 000 CU;
- ***Upward revaluation*** of PPE of 580 CU (revaluation model under IAS 16 is applied);
- ***Net profit*** for the year 20X3 of 4 800 CU.

During 20X4 (that is one year later), the following transactions occurred:

- ***Issue of 2 000 new 1 CU shares*** at 1.10 per share;
- Payment of ***dividends*** to JBC's shareholders of 2 500 CU;
- ***Downward revaluation*** of PPE of 200 CU (revaluation model under IAS 16 is applied);
- ***Net profit*** for the year 20X3 of 5 300 CU.

Prepare the statement of changes in equity for the year ended 31 December 20X4.

Solution: Statement of changes in equity

It is always great to prepare the blank statement of changes in equity, and we can follow the format as suggested by implementation examples in IFRS 18.

Here's just that:

XY Group - Consolidated Statement of Changes in Equity for the year ended 31 December 20X4
(in thousands EUR)

	Share capital	Share premium	Retained earnings	Revaluation of financial assets	Reval. surplus	Total equity attributable to the owners of the parent	Non-controlling interest	Total equity
Balance at 1 Jan 20X3								
Changes in accounting policy								
Restated balance								
Changes in equity for 20X3: Dividends paid; TCI for the year								
Balance at 31 Dec 20X3:								
Changes in equity for 20X4: *Issue of shares*; *Dividends paid*								
TCI for the year								
Balance at 31 Dec 20X4:								

Comparatives 20X3

Current year 20X4

Then, we are going to fill in the gaps, starting with the opening balances and adding the respective transactions. ***Please watch the video below for the precise method.***

A few remarks:

- Please note that the ***change in accounting policy is reported separately*** from the changes in equity, since this is a restatement. Also, we present the original balance prior restatement, as well as restated balance.
- Note that the ***issue of new shares is reported in split between two columns***, since this transaction affected two items: share capital (in its nominal amount of 1 CU per share) and share premium (the excess over nominal).
- ***Other comprehensive income is presented in one line***, split into individual movements. In this example, we have just one movement (revaluation surplus), but there could be some other movements, for example cash flow hedge reserve, etc.
- ***Profit (or loss)*** for the period is reported in the ***separate line***.
- There is a ***subtotal for total comprehensive income***, being the profit for the period plus other comprehensive income.

- The statement has ***2 parts***: one for ***comparatives (20X3)*** and one for the ***current reporting period (20X4)***.
- There is ***no non-controlling interest***, because we are preparing the individual, separate statement of changes in equity.

The statement of changes in equity is as follows:

JBC Plc. - Statement of Changes in Equity
31 December 20X4
(in thousands EUR)

	Share capital	***Share premium***	***Retained earnings***	***Revaluation surplus (PPE)***	**Total equity attributable to the owners of the parent**
Balance at 1 Jan 20X3	10 000	1 100	5 240	1 000	***17 340***
Changes in accounting policy			660		***660***
Restated balance	**10 000**	**1 100**	**5 900**	**1 000**	**18 000**
Changes in equity for 20X3:					
Dividends paid			(3 000)		***(3 000)***
Profit or loss			*4 800*		***4 800***
Other comprehensive income				*580*	***580***
TCI for the year			4 800	580	***5 380***
Balance at 31 Dec 20X3:	**10 000**	**1 100**	**7 700**	**1 580**	**20 380**
Changes in equity for 20X4:					
Issue of shares	2 000	200			***2 200***
Dividends paid			(2 500)		***(2 500)***
Profit or loss			*5 300*		***5 300***
Other comprehensive income				*(200)*	***(200)***
TCI for the year			5 300	(200)	**5 100**
Balance at 31 Dec 20X4:	**12 000**	**1 300**	**10 500**	**1 380**	**25 180**

THEME 15. CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

<u>1. Read the article and discuss</u>

INTRO TO CONSOLIDATION AND GROUP ACCOUNTS – WHICH METHOD FOR YOUR INVESTMENT?

Group accounting – what to do and how to start? The accounting method depends on the type of investment that an investor has.

IFRS Accounting Standards Dealing with Group Accounts

There are ***6 IFRS standards*** dealing with group accounts:

1. IAS 27 Separate Financial Statements

This standard prescribes how the investor shall present its investments in the ***individual or separate (non-consolidated) financial statements.***

2. IAS 28 Investments in Associates and Joint Ventures

IAS 28 prescribes the accounting treatment of ***associates***, or the entities in which the investor has significant influence (but not control or joint control).

Also, it prescribes applying equity method of accounting for both associates and joint ventures (those are one type of joint arrangements under IFRS 11 Joint Arrangements).

3. IFRS 3 Business Combinations

IFRS 3 outlines the accounting when the investor ***obtains a control over its investment***.

People are often confused because both IFRS 3 and IFRS 10 deal with this situation, but each of these standards deals with its own aspects of the same thing.

IFRS 3 tells us what the ***business combination is***, how to account for it at the recognition (but not when you perform consolidation afterwards – then it's IFRS 10), how to measure goodwill, non-controlling interest and assets and liabilities acquired.

4. IFRS 10 Consolidated Financial Statements

This is the second standard dealing with the situation when the investor obtains a control over its investment.

As opposed to IFRS 3 mentioned above, IFRS 10 ***defines the control*** and gives a guidance to identify whether there is a control or not.

Then it also prescribes the ***consolidation procedures*** for preparing consolidated financial statements.

5. IFRS 11 Joint Arrangements

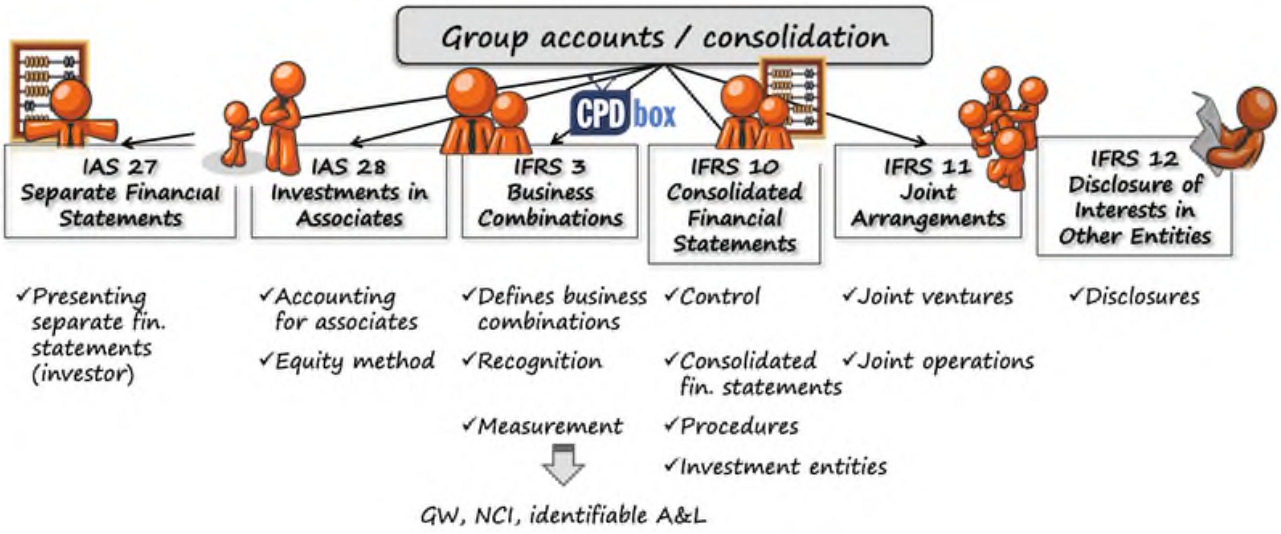
IFRS 11 deals with the third type of investment – ***joint arrangement***, which could be a joint operation or joint venture. In both cases, investor obtains joint control over some business with some other investor.

Before 2013, IAS 28 included the rules for joint arrangements, but now, we should look to IFRS 11.

6. IFRS 12 Disclosure of Interests in Other Entities

IFRS 12 relates to all types of interests in other entities: subsidiaries, associates, joint arrangements and unconsolidated structured entities.

It requires ***disclosures*** of various kind of information about these interests.



How to Account for Your Investment

As I've already mentioned above, you should first determine ***WHAT TYPE of investment*** you deal with and based on the type, ***apply specified accounting treatment.***

There are the 4 basic types of investments:

1. Subsidiaries

IFRS 10 defines a ***subsidiary*** as "an entity controlled by another entity".

The basic indicator of having a control over subsidiary is the size of your share in it. If you own ***more than 50%*** of investment's shares, then it indicates ***you control it.***

However, that's not always the truth and sometimes, investor does NOT have a control even if it owns more than 50% of shares. The opposite may be true: investor can have a control despite the share lower than 50%.

If there is a control, then investor must account for such an investment using the ***acquisition method*** and apply ***full consolidation procedures*** when making consolidated financial statements.

2. Associates

IAS 28 defines an ***associate*** as "an entity over which an investor has significant influence and which is neither a subsidiary nor an interest in joint venture".

Here, the basic indicator of significant influence is the investors ***share between 20% and 50%***, but similarly as with subsidiaries and control, there are situations where significant influence might or might not be demonstrated regardless the size of ownership.

If there's a significant influence, then investor must account for such an investment using the ***equity method.***

3. Joint Arrangements

IFRS 11 defines ***joint arrangement*** as "arrangement of which 2 or more parties have joint control".

It does not make any sense to quantify the "share" here, because it should be ***equal*** for all the parties. So if there are 2 parties of arrangement, each party has 50% share. If there are 3 parties, each party has 33.3% share – you get the idea.

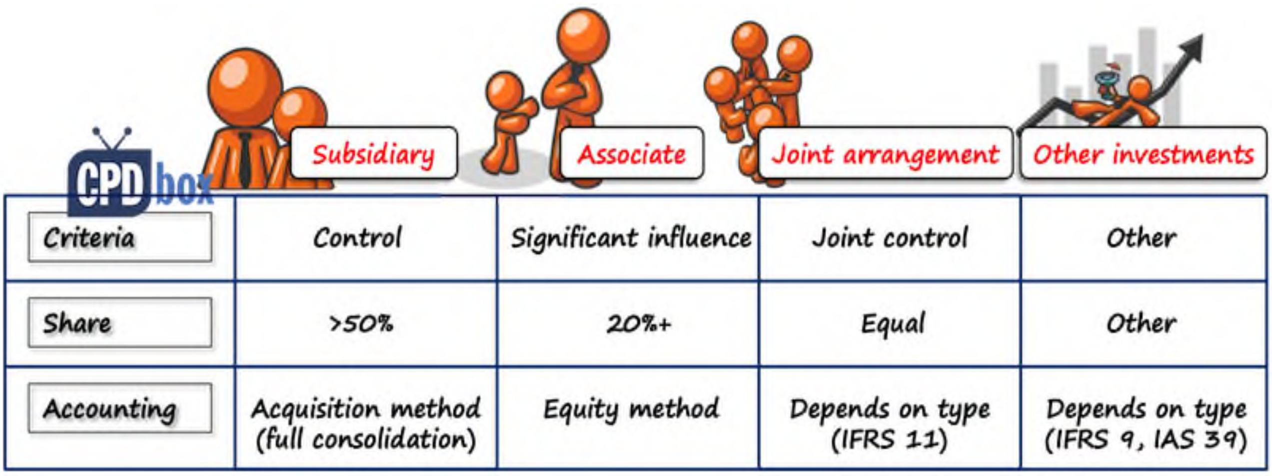
Instead, parties need to ***exercise joint control*** over the arrangement. It means that important decisions require unanimous consent of all parties of the arrangement and no single party can decide independently.

IFRS 11 requires accounting for joint arrangement based on its specific type:

- If parties established ***joint venture***, then each party accounts for its investment using the ***equity method*** in line with IAS 28, and
- If parties established ***joint operation***, then each party accounts for its own assets, liabilities, expenses, revenues and its share on all items incurred jointly.

4. Other Investments

If an investor acquires any other investment that does not fall into any of above categories, then it is accounted for as a ***financial instrument*** in line with IFRS 9.



<u>2. Read the article and discuss</u>

EXAMPLE: HOW TO CONSOLIDATE

What's the situation?

Here's the question:

Mommy Corp purchased 80% shares of Baby Ltd. a few years ago.

Below there are statements of financial positions of both Mommy and Baby at 31 December 20X4.

Statement of financial position as at 31 December 20X4	Mommy Corp.	Baby Ltd.
ASSETS		
Non-current assets		
Property, plant and equipment	120 000	90 000
Investment in Baby Ltd. (64 000 shares)	70 000	0
Goodwill acquired in a business combination		
Deferred tax asset	4 000	
	194 000	***90 000***
Current assets		
Inventories	55 000	34 000
Trade and other receivables		
Baby Ltd	8 000	
Other receivables	30 000	18 000
Cash and cash equivalents	20 000	5 000
	113 000	***57 000***
TOTAL ASSETS	**307 000**	**147 000**
EQUITY & LIABILITIES		
Equity		
Equity attributable to owners of the parent		
200 000 shares (1 CU each)	-200 000	
80 000 shares (1 CU each)		-80 000
Retained earnings	-62 000	-45 000
Non-controlling interest		
	-262 000	***-125 000***
Liabilities		
Non-current liabilities		
Deferred tax liability		-2 000
Current liabilities		
Trade payables		
Mommy Corp.		-8 000
Other payables	-35 000	-12 000
Loans repayable within 12 months	-10 000	
	-45 000	***-22 000***
TOTAL EQUITY & LIABILITIES	**-307 000**	**-147 000**
CHECK	0	0

Prepare consolidated statement of financial position of Mommy Group as at 31 December 20X4. Measure NCI at its proportionate share of Baby's net assets. All retained earnings of Baby are post-acquisition.

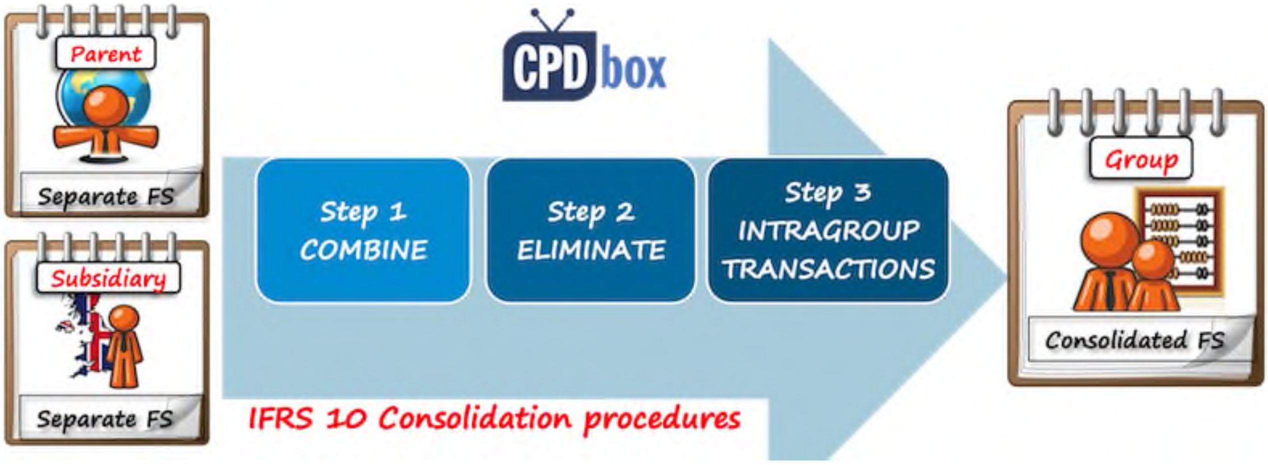
Please note here that in the above statements of financial position, ***all assets are with*** ***"+"*** and ***all liabilities are with*** ***"-"***. I use it this way because for me it's easier to verify and identify mistakes, but it's up to you.

3 Steps in Consolidation Procedures

I have described the consolidation procedures and their 3-step process in my previous article with the summary of IFRS 10 Consolidated financial statements, but let me repeat it here and follow these steps:

1. ***Combine*** like items of assets, liabilities, equity, income, expenses and cash

flows of the parent with those of its subsidiaries;
2. ***Offset (eliminate):***
    - the carrying amount of the parent's investment in each subsidiary; and
    - the parent's portion of equity of each subsidiary;
3. Eliminate in full ***intragroup*** assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group.



Step 1: Combine

After you make sure that all subsidiary's assets and liabilities are stated at fair values and all the other conditions are met, you can combine, or ***add up*** like items.

It's very easy when a parent (Mommy) and a subsidiary (Baby) use the same format of the statement of financial position – you just add Mommy's PPE and Baby's PPE, Mommy's cash and Baby's cash balance, etc.

In reality, companies use their own format for presenting their financial position and therefore it can be difficult to combine. That's exactly WHY so many groups use their "***consolidation packages***" and subsidiaries' accountants must fill them up along with preparing own financial statements.

Therefore, when a group controller calls you every five minutes to remind you the consolidation package, you'll know why!

In our case study, combined numbers looks as follows:

Statement of financial position as at 31 December 20X4	Mommy Corp.	Baby Ltd.	STEP 1 Combine
ASSETS			
Non-current assets			
Property, plant and equipment	120 000	90 000	210 000
Investment in Baby Ltd. (64 000 shares)	70 000	0	70 000
Goodwill acquired in a business combination			
Deferred tax asset	4 000		4 000
	194 000	***90 000***	***284 000***
Current assets			0
Inventories	55 000	34 000	89 000
Trade and other receivables			0
Baby Ltd	8 000		8 000
Other receivables	30 000	18 000	48 000
Cash and cash equivalents	20 000	5 000	25 000
	113 000	***57 000***	***170 000***
TOTAL ASSETS	**307 000**	**147 000**	**454 000**
EQUITY & LIABILITIES			
Equity			
Equity attributable to owners of the parent			
200 000 shares (1 CU each)	-200 000		-200 000
80 000 shares (1 CU each)		-80 000	-80 000
Retained earnings	-62 000	-45 000	-107 000
Non-controlling interest			
	-262 000	***-125 000***	***-387 000***
Liabilities			0
Non-current liabilities			0
Deferred tax liability		-2 000	-2 000
Current liabilities			0
Trade payables			0
Mommy Corp.		-8 000	-8 000
Other payables	-35 000	-12 000	-47 000
Loans repayable within 12 months	-10 000		-10 000
	-45 000	***-22 000***	***-67 000***
TOTAL EQUITY & LIABILITIES	**-307 000**	**-147 000**	**-454 000**
CHECK	0	0	0

Combined PPE of CU 210 000 =
Mommy's PPE of CU 120 000
+
Baby's PPE of CU 90 000
(continue with all items)

Of course, there are some strange and redundant numbers, for example both Mommy's and Baby's share capital, but we haven't finished yet!

Step 2: Eliminate

After combining like items, we need to ***offset (eliminate)***:

- the carrying amount of the parent's investment in each subsidiary; and
- the parent's portion of equity of each subsidiary;

and of course, recognize any non-controlling interest and goodwill.

So let's proceed. The first two items are easy – just ***remove Mommy's investment into Baby*** (CU – 70 000), and ***remove Baby's share capital in full*** (CU + 80 000).

As there is some ***non-controlling interest of 20%*** (please see below), you need to remove ***its share in Baby's post-acquisition retained earnings*** of CU 9 000 (20%*CU 45 000).

Wait a second – how do we know that all Baby's reserves (retained earnings) of CU 45 000 are post-acquisition?

Well, the question says that the full Baby's retained earnings are post-acquisition, otherwise you need to trace it.

Be careful here, because you absolutely need to ***differentiate pre-acquisition retained earnings from post-acquisition retained earnings***, but here, we're not going to complicate the things.

Then we need to recognize any non-controlling interest and goodwill.

Non-controlling interest at 31 December 20X4

Mommy has owned 80% of Baby's share and therefore, non-controlling interest owns ***remaining 20%*** of Baby's net assets.

The question asks to measure non-controlling interest at proportionate share on Baby's net assets, so here's how it looks like at the end of the reporting period:

Baby's net assets are CU 125 000 as at 31 December 20X4, including Baby's share capital of CU 80 000 and Baby's post-acquisition reserves of CU 45 000.

Non-controlling interest at 31 December 20X4 is 20% of Baby's net assets of CU 125 000, which is ***CU 25 000***. Recognize it with minus, as we are crediting equity with non-controlling interest.

Initial recognition of goodwill

There might be some goodwill arisen on initial recognition. If you'd like to learn more about goodwill, please refer to the article about IFRS 3 Business Combinations.

Let's calculate it. Please don't forget that ***we calculate goodwill based on numbers on acquisition***, not on 31 December 20X4.

The goodwill is calculated as:

- ***Fair value of consideration transferred***: in this case, we simply take Mommy's investment in Baby of CU 70 000;
- ***Add any non-controlling interest at acquisition***: here, we're not adding the non-controlling interest calculated above, as it's the measurement on 31 December 20X4. At acquisition, the value of non-controlling interest is 20% of Baby's net assets on its incorporation of CU 80 000 (share capital only). It equals CU 16 000.
- When a business combination was achieved in stages, you would need to add the acquisition-date fair value of the acquirer's previously-held equity interest in the acquiree, but in this example, it's not applicable,
- ***Deduct Baby's net assets at acquisition:*** CU – 80 000.

Goodwill acquired in a business combination comes to CU 6 000 (70 000 + 16 000 – 80 000).

The elimination entry looks as follows (sign "+" indicates a debit entry; sign "-" indicates a credit entry):

Description	Amount	Debit	Credit
Remove Mommy's investment in Baby	-70 000		FP – Investment in Baby
Remove Baby's share capital in full	+80 000	FP – Baby's share capital	
Remove 20% (NCI) of Baby's post-acquisition retained earnings	+9 000	FP – Retained earnings	
Recognize non-controlling interest on 31 December 20X4	-25 000		FP – Non-controlling interest
Recognize goodwill acquired in a business combination	+6 000	FP – Intangible assets (goodwill)	
Check	***0***		

I have transferred this journal entry into our consolidation worksheet and it looks as follows:

Statement of financial position as at 31 December 20X4	Mommy Corp.	Baby Ltd.	STEP 1 *Combine*	STEP 2 *Eliminate*
ASSETS				
Non-current assets				
Property, plant and equipment	120 000	90 000	210 000	
Investment in Baby Ltd. (64 000 shares)	70 000	0	70 000	-70 000
Goodwill acquired in a business combination				6 000
Deferred tax asset	4 000		4 000	
	194 000	***90 000***	***284 000***	
Current assets			0	
Inventories	55 000	34 000	89 000	
Trade and other receivables			0	
Baby Ltd	8 000		8 000	
Other receivables	30 000	18 000	48 000	
Cash and cash equivalents	20 000	5 000	25 000	
	113 000	***57 000***	***170 000***	
TOTAL ASSETS	**307 000**	**147 000**	**454 000**	
EQUITY & LIABILITIES				
Equity				
Equity attributable to owners of the parent				
200 000 shares (1 CU each)	-200 000		-200 000	
80 000 shares (1 CU each)		-80 000	-80 000	80 000
Retained earnings	-62 000	-45 000	-107 000	9 000
Non-controlling interest				-25 000
	-262 000	***-125 000***	***-387 000***	
Liabilities			0	
Non-current liabilities			0	
Deferred tax liability		-2 000	-2 000	
Current liabilities			0	
Trade payables			0	
Mommy Corp.		-8 000	-8 000	
Other payables	-35 000	-12 000	-47 000	
Loans repayable within 12 months	-10 000		-10 000	
	-45 000	***-22 000***	***-67 000***	
TOTAL EQUITY & LIABILITIES	**-307 000**	**-147 000**	**-454 000**	
CHECK	0	0	0	0

This is eliminating journal entry as explained above. Please note:
+ = Debit; Assets
- = Credit; Equity&Liabilities

Eliminate Intragroup Transactions

Parents and subsidiaries trade with each other very often.

However, when you look at both parent and subsidiary as at 1 company, which is the purpose of consolidation, then you find out that there's no transaction at all.

In other words, group has not performed any transaction from the view of some external user.

Therefore you need to ***eliminate all transactions happening within the group***, between a parent and its subsidiaries.

Looking to above individual statements of financial position of Mommy and Baby you see that ***Mommy has a receivable to Baby of CU 8 000*** and ***Baby has a payable to Mommy of CU 8 000***. Perhaps these 2 items relate to the same transaction between them and we need to eliminate them, by ***debiting payables and crediting receivables***:

Statement of financial position as at 31 December 20X4	Mommy Corp.	Baby Ltd.	STEP 1 *Combine*	STEP 2 *Eliminate*	STEP 3 *Intragroup*
ASSETS					
Non-current assets					
Property, plant and equipment	120 000	90 000	210 000		
Investment in Baby Ltd. (64 000 shares)	70 000	0	70 000	-70 000	
Goodwill acquired in a business combination				6 000	
Deferred tax asset	4 000		4 000		
	194 000	***90 000***	***284 000***		
Current assets			0		
Inventories	55 000	34 000	89 000		
Trade and other receivables			0		
Baby Ltd	8 000		8 000		-8 000
Other receivables	30 000	18 000	48 000		
Cash and cash equivalents	20 000	5 000	25 000		
	113 000	***57 000***	***170 000***		
TOTAL ASSETS	**307 000**	**147 000**	**454 000**		
EQUITY & LIABILITIES					
Equity					
Equity attributable to owners of the parent					
200 000 shares (1 CU each)	-200 000		-200 000		
80 000 shares (1 CU each)		-80 000	-80 000	80 000	
Retained earnings	-62 000	-45 000	-107 000	9 000	
Non-controlling interest				-25 000	
	-262 000	***-125 000***	***-387 000***		
Liabilities			0		
Non-current liabilities			0		
Deferred tax liability		-2 000	-2 000		
Current liabilities			0		
Trade payables			0		
Mommy Corp.		-8 000	-8 000		8 000
Other payables	-35 000	-12 000	-47 000		
Loans repayable within 12 months	-10 000		-10 000		
	-45 000	***-22 000***	***-67 000***		
TOTAL EQUITY & LIABILITIES	**-307 000**	**-147 000**	**-454 000**		
CHECK	0	0	0	0	0

Final steps

After we have completed all steps or consolidation procedures, we can add up all the combined numbers with our adjustments and thus we arrive at consolidated statement of financial position.

You can revise all the steps and formulas in Excel file that you can download at the end of this article.

Here's how it looks like:

Statement of financial position as at 31 December 20X4	Mommy Corp.	Baby Ltd.	STEP 1 *Combine*	STEP 2 *Eliminate*	STEP 3 *Intragroup*	Mommy Group Consolidated *St of FP*
ASSETS						
Non-current assets			SUM OF STEPS 1-3			
Property, plant and equipment	120 000	90 000	210 000			210 000
Investment in Baby Ltd. (64 000 shares)	70 000	0	70 000	-70 000		0
Goodwill acquired in a business combination				6 000		6 000
Deferred tax asset	4 000		4 000			4 000
	194 000	***90 000***	***284 000***			220 000
Current assets			0			
Inventories	55 000	34 000	89 000			89 000
Trade and other receivables			0			0
Baby Ltd	8 000		8 000		-8 000	0
Other receivables	30 000	18 000	48 000			48 000
Cash and cash equivalents	20 000	5 000	25 000			25 000
	113 000	***57 000***	***170 000***			162 000
TOTAL ASSETS	**307 000**	**147 000**	**454 000**			**382 000**
EQUITY & LIABILITIES						
Equity						
Equity attributable to owners of the parent						
200 000 shares (1 CU each)	-200 000		-200 000			-200 000
80 000 shares (1 CU each)		-80 000	-80 000	80 000		0
Retained earnings	-62 000	-45 000	-107 000	9 000		-98 000
Non-controlling interest				-25 000		-25 000
	-262 000	***-125 000***	***-387 000***			-323 000
Liabilities			0			
Non-current liabilities			0			
Deferred tax liability		-2 000	-2 000			-2 000
Current liabilities			0			
Trade payables			0			0
Mommy Corp.		-8 000	-8 000		8 000	0
Other payables	-35 000	-12 000	-47 000			-47 000
Loans repayable within 12 months	-10 000		-10 000			-10 000
	-45 000	***-22 000***	***-67 000***			-59 000
TOTAL EQUITY & LIABILITIES	**-307 000**	**-147 000**	**-454 000**			**-382 000**
CHECK	0	0	0	0	0	0

Please note the following facts:

- Consolidated numbers are simply sum of Mommy's balance, Baby's balance and all adjustments or entries (Steps 1-3).
- Mommy's investment in Baby's shares is 0 as we eliminated it in the step 2. The same applies for Baby's share capital and consolidated statement of financial position shows only a share capital of Mommy (parent).
- There's a goodwill of CU 6 000 and non-controlling interest of CU 25 000, as we have calculated above.
- ***Consolidated retained earnings*** are CU 98 000 and they consist of:
  - Mommy's retained earnings of CU 62 000 in full, and
  - Mommy's share (80%) on Baby's post-acquisition retained earnings of CU 45 000, that is CU 36 000

Is consolidation really easy?

Sometimes.

But in most cases, there is lots of issues or circumstances that you need to take into account and exactly their significance and amount makes it all difficult.

What issues? For example:

Consideration transferred for acquiring the shares may involve not only cash, but also some other forms, such as share issue, contingent consideration, transfers of assets, etc.

Non-controlling interest can be measured at fair value instead of at proportionate share.

There might be some unrealized profit on transactions within the group and it needs to be eliminated.

There might be some transfer of property, plant and equipment at profit within the group and as a result, you need to adjust both unrealized profit and depreciation charge, too.

Goodwill might be either positive or negative (=gain on a bargain purchase). Moreover, it can be impaired.

Subsidiary's net assets might be stated in the amounts different from their fair value, or even not recognized at all.

Subsidiary may show both pre-acquisition retained earnings and post-acquisition retained earnings. You need to be extremely careful in differentiating them and dealing with them separately.

THEME 16. ACCOUNTING POLICIES AND EVENTS AFTER THE REPORTING PERIOD

<u>1. Read the article and discuss</u>

HOW TO ACCOUNT FOR FREE ASSETS RECEIVED UNDER IFRS

The best things in life are free…

… at least that's what Janet Jackson sang in one of her top hits.

However, when your company receives some free assets, then the question is:

Are they really received at no cost and no strings attached?

Is there something else behind?

Many years ago I attended the counting of fixed assets in one big manufacturing company.

It was a freezing December morning, huge piles of snow made it quite difficult to get around and we were sneaking in and counting various types of machines in the client's storage.

One of my colleagues spotted some cooling units, new – still unpacked, and he could not find them in the document with the register of fixed assets, so he asked:

" Why are these cooling units not recorded in the register?"

The boss of the warehouse, a bored grey-haired guy, murmured with the tobacco pipe between his teeth something like:

"Oh gosh. We did not buy them. We got them free when we purchased the machines."

Sorry, I don't remember now what machines they purchased, but I remember the discussion with the accounting manager that followed.

So ***what should you do in a similar situation, when you receive some free assets?***

In this article I try to tackle this quite frequent issue and give you some hints.

Before you start: Is it material?

You need to ***apply your judgment*** to assess whether your free asset received is material enough to bother.

For example – when you receive pens, lighters or other promotional materials, they might not make any difference in your books, so just don't worry about their accounting.

The same applies in a multibillion dollar company that pays monthly telecom plans for their 100 executives and receives 100 mobile phones at no cost from the network provider.

Is their aggregate amount material?

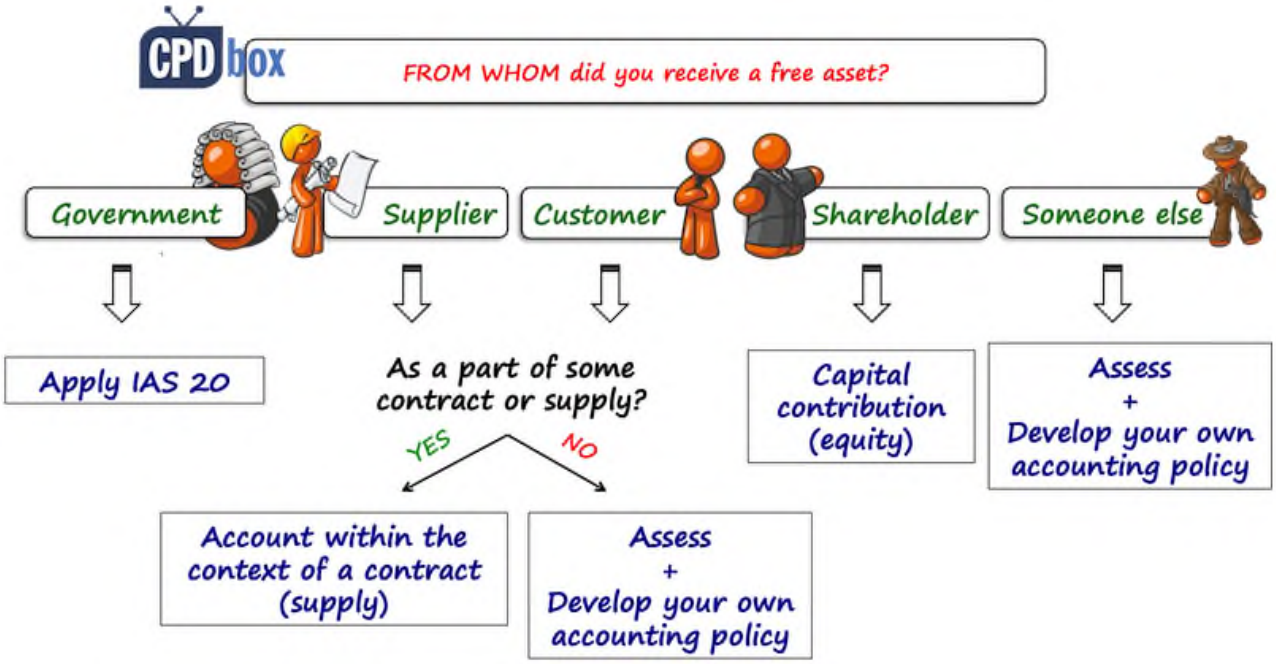
If not, just don't bother.

If yes, continue reading.

The starting point: Why did you receive your free asset?

Let's say you received a significant asset.

For example, some piece of equipment, free land or something like that. The first thing you need to examine is ***why and who the donor was***. What is the substance of this transaction?
Even more important: Whom did you receive the free asset from?
The accounting treatment will then depend on your answer.



#1: Free asset from government

If you received a free asset as a form of government grant, then the accounting is clear – you need to follow IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.

What counts as "a government"?

Besides government, also government agencies and similar local, national or international bodies count as "government" for the purpose of IAS 20.

So, even if you received your grant from IMF, EU, WHO or similar organizations, you need to follow IAS 20.

#2: Free asset from your supplier

You can receive free assets from your suppliers for a number of reasons and in a number of ways.

The question is: ***Did you receive a free asset as a part of some contract, together with the purchase of something else?***

If yes, then you might need to ***allocate a part of total purchase price to the "free asset".***

Example: Free asset from a supplier

Let's say you enter into a contract with a supplier to acquire 3 big pieces of machinery and the contract says that the total price is CU 3 000 for those 3 pieces (CU 1 000 each).

And, the contract says that the supplier will deliver also a cooling unit

(=separate asset) at no additional cost.

A big mistake that many companies make is that they do not recognize a free asset at all.

However, the Conceptual Framework for Financial Reporting asks you to report any asset that you control.

Thus, it is a misstatement if you ignore your free asset, you use it – but you do not show it in your financial statements.

So what to do in this case?

Well, you should ***measure the free asset – a cooling unit in this case – at its cost***.

The total cost for 3 machines and 1 cooling unit is CU 3 000, so you should ***allocate this total purchase price to all assets*** based on their fair values, or current selling prices if they are new.

Let’s say that the similar cooling unit trades for CU 300.

Then the total of selling prices is CU 3 300 (3 000 for machines and 300 for cooling unit).

Thus you allocate CU 909 to each machine (= CU 1 000/3 300 * 3 000) and CU 273 to the cooling unit (= CU 300/3 300*3 000). Total allocated cost is 909*3+273 = CU 3 000.

Now, many might think that it is not OK since the cost of one machine is CU 1 000.

Well, the standard IAS 16 says that the cost is the ***purchase price less discount*** and “free” cooling unit is a sort of a discount, don’t you think?

Another case of free assets received from suppliers is when you receive an asset as a gift for your long-term loyalty or a support of a promotional campaign.

For example, a supplier might sponsor the renovation of your shop and display area.

In this case, it would be very hard and impracticable to allocate a part of purchase price of other products to this free asset.

Therefore, you need to adopt different solution. Just go on reading.

#3: Free asset from your customer

Here, there’s a similar question as with suppliers: Is a free asset received under some contract with your customer?

If yes, then you might need to apply IFRS 15 Revenue from Contracts with Customers and assess the situation carefully (IFRIC 18 applied in the past).

In this case, when you receive a free asset from your customer within some contract, is it considered as ***non-cash consideration***.

The article IFRS 15.66 requires ***including the fair value of non-cash consideration in the transaction price***.

Example: Free asset from customer

Let’s say that you enter into a contract with a manufacturing company to process some wood for their one-off project.

You agree that you will use the client’s wood processing machine.

The contract specifies that the price for the wood processing is CU 1 000 and you can keep the machine (since the client will not need it anymore and it is not new).

Let's say that the fair value of a machine is CU 300.

Thus your transaction price is CU 1 300 and you will recognize the machine at its fair value of CU 300 (it then becomes machine's cost) at the moment when you gain the ***full control of a machine***.

When that happens?

It depends on the specifics of the contract – sometimes it may happen right in the start of executing the contract (e.g. you take the machine to your premises and work there), sometimes it may happen in a different time (e.g. when you can use the machine only at your client's premises and take it only after the contract is executed).

If you receive a free asset from a customer outside any contract, then again, you need to find a different solution. Read on!

#4: Free asset received from your shareholder

Shareholders often give free assets to their investees.

We can regularly see big transfers of various types of assets, including machinery, lands and sometimes buildings from a parent to its subsidiary.

In this case, if you gain ***control of an asset***, you should recognize it ***at fair value*** – which becomes its cost.

As this is a contribution from shareholder, you should NOT recognize it as an income in your profit or loss.

Conceptual Framework strictly excludes contributions from shareholders from the definition of income.

Instead, the shareholder increases its investment in a subsidiary and a subsidiary shows the receipt of a free asset ***directly in equity as a capital contribution*** from a shareholder.

#5: Free asset received from other parties

Yes, it may occasionally happen.

You can receive a free asset from anybody as a gift, with no strings attached.

One example comes to my mind from the past: a hospital receiving USG and other machines from a cancelled hospital at no cost.

In this case, you need to ***develop your own accounting policy***, because IFRS do not contain any guidance on how to do it.

And, I would say that this applies also to ***free assets received from your suppliers or customers where it is impossible or impracticable*** to match these free assets with any contracts.

We need to develop the accounting policybased on the similar rules in other standards and the Framework.

What are the closest similar rules?

Yes, you guessed it – the standard IAS 20 that applies for government grants.

Let me give you a few considerations here:

1. First of all – you need to ***show assets that you control***. I have already wrote that above.
2. Secondly – as you have no cost, the ***fair value concept*** applies here.
3. You should ***not show the receipt of your free asset directly in the equity*** because it does not come from your shareholder.

Analogically, IAS 20 strictly prohibits accounting for grants straight in equity, so we should be consistent with this rules when forming the accounting policy in this case.

Now, this is the hardest part – ***how should you recognize the free asset*** that you received?

In other words – what is the ***credit entry***?

Here, I would show the credit entry as ***income in profit or loss***.

Not the revenue, because the revenue comes from ordinary course of business.

The ***journal entry*** looks something like that:

- Debit PPE – asset: fair value
- Credit Profit or loss – other income: fair value

Why not deferred income with subsequent amortization of a deferred income in profit or loss?

OK, I know that it is the treatment required by IAS 20 for government grants, however:

In this case, there are no strings attached in a sense that you do not have to hold the free asset and use it.

You do not have any conditions attached to the receipt of a free asset, right?

Therefore I believe that the receipt of your free asset indeed represents an ***increase in your net assets at the moment when you receive the asset*** and your financial statements should reflect that increase.

If you recognize your free asset in deferred income (liability in the balance sheet), then you are not showing the increase in your net assets.

Also, someone might argue that you are not in line with matching concept because you are not matching the income (receipt of a free asset) with the expenses (its depreciation).

Well, let me explain that IFRS do NOT contain anything like general matching concept – not at all.

But, IFRS tell you to recognize ***expenses when the relevant service or asset was consumed*** (thus together with the depreciation).

Also, IFRS tell you that the income "is recognized in the income statement when an ***increase in future economic benefits*** related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably" (see Conceptual Framework).

Thus it is perfectly OK and in line with the Conceptual Framework to recognize an income from the receipt of a free asset when it is received and not over its useful life with amortization.

Why is it different from the treatment of government grants under IAS 20?

Well, exactly as I wrote above – government gives you grants (free assets or cash) for some purpose.

In most cases, you need to meet certain conditions to get the grant and afterwards.

Therefore receipt of a free asset from anyone else is different, especially if there are no strings attached.

BUT!!!

If you receive free asset from an entity other than government and there ARE conditions attached to it, then of course, IAS 20 treatment (via deferred income) is more suitable policy choice in this case.

THEME 17. INTEGRATED REPORTING

1. Read the article and discuss

The International Integrated Reporting Framework and Integrated Thinking Principles have been developed and are used around the world, in 75 countries, to advance communication about value creation, preservation and erosion.

The cycle of integrated reporting and thinking result in efficient and productive capital allocation, acting as a force for financial stability and sustainable development.

Integrated reporting aims to:

- Improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital
- Promote a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organisation to create value over time
- Enhance accountability and stewardship for the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of their independencies
- Support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.

The Integrated Reporting Framework and Integrated Thinking Principles are maintained under the auspices of the IFRS Foundation, a global not-for-profit, public interest organisation established to develop high-quality, understandable, enforceable and globally accepted accounting and sustainability disclosure standards.

The Integrated Reporting Framework is used to connect financial statements and sustainability-related financial disclosures.

The IFRS Foundation's International Accounting Standards Board (IASB) and International Sustainability Standards Board (ISSB) are jointly responsible for the Integrated Reporting Framework.

Integrated reporting examples database

This database contains examples of emerging practice in integrated reporting that illustrate how organisations are currently reporting concise information about how their strategy, governance, performance and prospects, in the context of their external environment, lead to the creation, preservation or erosion of value over the short, medium and long term.

Featured practice examples are carefully selected by the Integrated Reporting and Connectivity staff of the IFRS Foundation, with recommendations received from integrated reporters and supporters around the world.

https://examples.integratedreporting.ifrs.org/featured-practices/

2. Read the article and discuss

INTEGRATED REPORTING: START WITH THE BUSINESS MODEL, AND START AT THE TOP

In our work as sustainability consultants, we see different ideas about what corporate managers think Integrated Reporting is and what the associated challenges and benefits are. We often observe that while many are interested in Integrated Reporting, they are also a bit daunted by it.

What Integrated Reporting Is – and What It Is Not

When we talk about Integrated Reporting (<IR>) at Sustainserv, we mean an annual report prepared in accordance with the framework of the International Integrated Reporting Council (IIRC). In this sense, an integrated report explains how a company creates, preserves and reduces financial and non-financial value in the short, medium and long term.

About the IIRC

The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs. Together, this coalition shares the view that communication about value creation, preservation or erosion is the next step in the evolution of corporate reporting.

An integrated report is not a sustainability report dropped into an annual report, and just because a company's annual report covers environmental, social and governance (ESG) topics in addition to economic topics does not make it an integrated report. True integrated reports center around interdependencies, coherences and linkages between financial and non-financial aspects and tangible and intangible assets.

In integrated reporting, the company is understood as a value-creation machine. A company depends on different types of resources that are used by business activities, which result in outputs like products, services and profits, but also other intended and unintended by-products, such as waste, empowered employees or carbon emissions. Integrated reporting also shows a company's impacts on all stakeholders – not just investors but also customers, employees, suppliers, the communities it operates in and the environment. In summary, an integrated report shows what a company creates value from and how, and all the ways it impacts people and the planet.

The Benefits of Integrated Reporting

The process of developing an integrated report helps identify the full range of factors that substantially affect the company's ability to create value, providing a better picture of the company's strengths, weaknesses, opportunities and threats. Integrated Reporting allows the company to better communicate its business activities, the resources it uses, the value it creates and the impacts it has. In short, it helps better understand and explain the company's business model and its resilience.

Integrated reporting also enables the company to position itself as strategically forward-looking and sustainably managed.

Furthermore, integrated reporting raises awareness – both internally and externally – of different types of value and the connections between them. This supports integrated management that not only focuses on short term value creation, but also medium and long-term value creation and promotes responsibility and accountability beyond financial value creation, which is the essence of sustainable business management.

“The IIRC’s long-term vision is a world in which integrated thinking is embedded within mainstream business practice in the public and private sectors, facilitated by integrated reporting as the corporate reporting norm. The cycle of integrated reporting and thinking, resulting in efficient and productive capital allocation, will act as a force for financial stability and sustainable development.”

Essentials for Success

To be successful, integrated reporting depends on senior management to be its champion from the outset. And it requires involvement from more departments – not just finance and communications. As a result, the report team will be much larger, and solid project management is a must.

Without an integrated business model, there can be no integrated report. The work begins with a thorough definition and understanding of the company’s model to create value – on the enterprise level. For many companies, this is new territory and is the tallest hurdle to get over.

Measure, measure, measure. It can’t be overstated the importance of measuring. Across the spectrum, and across all dimensions, data is critical for telling a compelling story and showing meaningful progress.

Five Steps to an Integrated Report

When a company decides to embark on an integrated reporting journey – or assess its feasibility – we typically recommend taking a five-step approach:

1. **Analyze the company’s status quo.**

What is already there? What is missing? What does it take to bring it all together? Start with a review of relevant existing elements in the sustainability report, annual report and corporate presentations, and identifying gaps for integrated reporting. Also, assess the connectivity of the existing elements to integrated reporting.

2. **Flesh out the integrated business model.**

What does a value-creation machine look like in concrete terms for the company? What resources are used and consumed? What are the business activities? What values are created and what effects do they have? Identify and describe the most important resources, business activities and results – such as products, services or by-products, and impacts of the entrepreneurial value creation. This also includes developing a summary of key trends and developments in the business environment and assessing how they impact the business, in order to show the context in which the company operates.

3. **Create a reporting concept.**

What are the contents? How are they structured? What are the key messages? What is the storyline? What design can best support the content? For this step, consider the reporting concept that best aligns with content and corporate culture and begin to get a picture of the report design.

4. **Gather targeted information and data.**

Collect data and information to fill gaps and improve connectivity of existing elements, and assess whether the data and information collected provide an integrated view of the business. If not, determine the action items needed to achieve a more complete picture.

5. **Prepare and publish the integrated report.**

Prepare report chapters based on the integrated business model, the reporting concept and the supporting data and information, coordinating with topic owners and senior management. Decide whether the integrated report is the central piece or a complementary document of your entire corporate reporting suite.

3. Read the article and discuss

WRITING THE FIRST INTEGRATED REPORT FOR OUR BUSINESS: WHAT WE'VE LEARNED

What is integrated reporting?

When you're telling your sustainability story, there are several options. You can add sustainability content to your annual report or produce a standalone sustainability report. This standalone report can follow the Global Reporting Initiative (GRI) Framework.

You can also choose the Integrated Reporting Framework, as we did. <IR> is a new way of thinking about sustainability and business value. It makes sustainability core to ('integrated in') how your organisation operates. <IR> shows how your organisation creates or erodes value over time through its inter-connected financial, social, environmental and governance resources. These resources are known as the six 'capitals':

- Financial capital (e.g. your business's financial resources)
- Manufactured capital (e.g. your buildings and equipment)
- Social and relational capital (e.g. relationships with your customers)
- Intellectual capital (e.g. your product's design)
- Natural capital (e.g. the energy and water you use)
- Human capital (e.g. your team's skills and knowledge).

Why we chose <IR> at thinkstep-anz

We like <IR> because the framework shows that sustainable business is about much more than short-term financial results. It's about creating and managing healthy, cohesive, connected systems over time.

We also like the focus on 'value'. <IR> helps us understand how our thinkstep-anz people, relationships, financial assets, knowledge, processes and environmental resources come together to create and preserve long-term value for our business. This focus on value shows us what we need to do to make progress and where our future opportunities and challenges lie. It also guides the data we need to collect to measure our progress.

Our tips for getting started

1. **Confirm your purpose.** Why are you writing an <IR>? To comply with reporting requirements? To summarise your sustainability programme for investors or customers who are asking about it? To communicate with local communities and suppliers? To take stock of your sustainability efforts?

2. **Confirm your audience.** This is related to your purpose. Who are you reporting to or communicating with? Your regulators? Your investors? Your customers, suppliers or team?

3. **Gain your mandate.** Check in with the people (usually your organisation's leaders) who will want to shape your <IR>. Get their ideas and confirm their support early. Then keep them updated.

4. **Get your 'building blocks' in place early.** Do a materiality assessment. Update your existing one if it's over three years old or something big has changed (e.g. you've created a new division). Confirm (or reconfirm) the Sustainable Development Goals that are relevant to your business. Advise team members that you'll be calling on them to provide data for the report. Survey your team to gain those interesting little insights. What does sustainability mean for you outside work? How do you travel? How do you dispose of waste?

5. **Look for inspiration.** Review others' reports to get ideas for your content and design.

6. **Get to grips with the <IR> language.** Concepts like the 'capitals' will be new to most people. Take time to educate them.

Our tips for managing your report

1. **Treat your <IR> as a project.** Develop a project plan with milestones such as sign-offs. Manage your stakeholders. Keep your team updated on progress.

2. **Assemble your project team.** Get the right people in the room from the start: your reporting manager (if you have one), your communications and design team, the people who'll provide your data.

3. **Set a timeframe – and stick to it.** It's like packing for a holiday. It takes as long as you let it!

Our tips for choosing your content

1. **Let your purpose and audience guide you.** Write for your reader and the outcomes you want to achieve.

2. **Show you understand the value of integrated thinking.** For example, in our thinkstep-anz <IR> we talk about sharing our skills and knowledge (intellectual capital) through our regular webinars, blogs and conferences. We show how these activities help us attract talented team members (human capital), build our client networks (social and relationships capital) and income (financial capital), and gain ideas for new services (intellectual capital).

3. **Be transparent.** Tell the bad as well as the good by including risks and downsides too. Declaring them will force you to mitigate them. (Then talk about your mitigation strategy.) Show what you've learned and educate others.

4. **Keep your organisation accountable.** Include sustainability targets and outcomes. If you've fallen short, explain why and how you're planning to make up ground.

5. **Make your content engaging.** Use case studies to tell your stories. Include content snippets suitable for 'breakout boxes' (e.g. 'Five things we've learned').

6. **Use plain English writing techniques.** Use 'dinner table language': concise, punchy language, short words and sentences. Headers will guide your reader through your report; tables will make detailed information easy to read. Make your <IR> a jargon-free zone. (Be gone, 'synergies', 'paradigms' and 'alignment'!)

7. **Use language that works for your stakeholders.** Don't follow the <IR> language slavishly. If 'our people' works better for your organisation than 'human capital', go ahead and use it.

8. **Keep your <IR> short.** Short reports get read and 'conciseness' is one of the <IR> framework's seven principles. Materiality (reporting what matters), Plain English techniques and infographics are your friends here.

9. **Banish greenwash!** A well written <IR> will boost your brand. Vague, misleading marketing statements that are not backed up by data will quickly erode it.

Our tips for designing your report

1. **Invest in design.** It will bring your content to life.

2. **Use infographics to highlight important content.** Infographics are particularly useful to summarise your:

- business model (how you work) to help your audiences understand integrated thinking and reporting
- value chain to highlight the value of strong relationships
- sustainability strategy to show how sustainability adds value to your business.

They're good for reporting against performance targets too.

3. **Source quality photos.** Use them to illustrate your organisation – who you are, what you do, how you work. Photos that feature people work well.

4. Read the article and discuss

IFRS SUSTAINABILITY REPORTING JUST BEHIND YOUR DOOR

Two newest standards, IFRS S1 and IFRS S2, were published in June 2023.

I think that's not news for anybody with two eyes and ears, because the information spread everywhere.

Well, my usual approach is rather practical, so I will skip all these talks about WHY we need sustainability and WHY it is good. We all know that already.

So let's focus on practical questions:

#1 When should we all apply IFRS S1 and IFRS S2?

Both standards are mandatorily applicable for annual reporting periods ***beginning on or after 1 January 2024***.

It practically means that you need to have the appropriate processes in place to monitor and gather all the data you need to provide, so that you can actually start gather the data from 1 January 2024.

Therefore, the first report with incorporating information related to IFRS S1 and IFRS S2 will be published sometime in 2025, related to the year 2024.

#2 What about comparatives?

The good news is that ***NO, you do not have to present comparative information in the first annual financial statements***, that would be related to the period before the date of initial application.

So no worries about monitoring and gathering data in 2023.

Of course, if you do that voluntarily, that's OK, you can present it.

#3 Is there any relief in reporting?

Yes, a bit.

You need to provide the disclosures on climate-related risks in the first place, in accordance with IFRS S2.

If you cannot disclose all the related disclosures in accordance with IFRS S1, then you do not need to do so, but only in the first annual reporting period when you apply the standards.

However, in these first annual financial statements with sustainability disclosures, you need to disclose the climate-related disclosures at minimum and then also state that you applied transition relief.

SUGGESTED READING

International Financial Reporting Standards (IFRS)

№	Name	Issued
IFRS 1	First-time Adoption of International Financial Reporting Standards	2008*
IFRS 2	Share-based Payment	2004
IFRS 3	Business Combinations	2008*
IFRS 4	Insurance Contracts	2004
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	2004
IFRS 6	Exploration for and Evaluation of Mineral Assets	2004
IFRS 7	Financial Instruments: Disclosures	2005
IFRS 8	Operating Segments	2006
IFRS 9	Financial Instruments	2013*
IFRS 10	Consolidated Financial Statements	2011
IFRS 11	Joint Arrangements	2011
IFRS 12	Disclosure of Interests in Other Entities	2011
IFRS 13	Fair Value Measurement	2011
IFRS 14	Regulatory Deferral Accounts	2014
IFRS 15	Revenue from Contracts with Customers	2014
IFRS 16	Leases	2016
IFRS 17	Insurance Contracts	2017
IFRS 18	Presentation and Disclosures in Financial Statements	2024
IFRS 19	Subsidiaries without Public Accountability: Disclosures	2024

International Accounting Standards (IASs)

№	Name	Issued
IAS 1	Presentation of Financial Statements	2007*
IAS 2	Inventories	2005*
IAS 7	Statement of Cash Flows	1992
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	2003
IAS 10	Events After the Reporting Period	2003
IAS 12	Income Taxes	1996*
IAS 16	Property, Plant and Equipment	2003*
IAS 19	Employee Benefits (2011)	2011*
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	1983
IAS 21	The Effects of Changes in Foreign Exchange Rates	2003*
IAS 23	Borrowing Costs	2007*
IAS 24	Related Party Disclosures	2009*

IAS 26	Accounting and Reporting by Retirement Benefit Plans	1987
IAS 27	Separate Financial Statements (2011)	2011
IAS 28	Investments in Associates and Joint Ventures (2011)	2011
IAS 29	Financial Reporting in Hyperinflationary Economies	1989
IAS 32	Financial Instruments: Presentation	2003*
IAS 33	Earnings Per Share	2003*
IAS 34	Interim Financial Reporting	1998
IAS 36	Impairment of Assets	2004*
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	1998
IAS 38	Intangible Assets	2004*
IAS 40	Investment Property	2003*
IAS 41	Agriculture	2001

IFRIC Interpretations

№	Name	Issued
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities	2004
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments	2004
IFRIC 4	Determining Whether an Arrangement Contains a Lease	2004
IFRIC 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds	2004
IFRIC 6	Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment	2005
IFRIC 7	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies	2005
IFRIC 9	Reassessment of Embedded Derivatives	2006
IFRIC 10	Interim Financial Reporting and Impairment	2006
IFRIC 12	Service Concession Arrangements	2006
IFRIC 14	IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction	2007
IFRIC 16	Hedges of a Net Investment in a Foreign Operation	2008
IFRIC 17	Distributions of Non-cash Assets to Owners	2008
IFRIC 18	Transfers of Assets from Customers	2009
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments	2009
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine	2011
IFRIC 21	Levies	2013
IFRIC 22	Foreign Currency Transactions and Advance Consideration	2016
IFRIC 23	Uncertainty over Income Tax Treatments	2017

SIC Interpretations

№	Name	Issued
SIC-7	Introduction of the Euro	1998
SIC-10	Government Assistance – No Specific Relation to Operating Activities	1998
SIC-15	Operating Leases – Incentives	1999
SIC-25	Income Taxes – Changes in the Tax Status of an Enterprise or its Shareholders	2000
SIC-27	Evaluating the Substance of Transactions in the Legal Form of a Lease	2000
SIC-29	Disclosure – Service Concession Arrangements	2001
SIC-32	Intangible Assets – Web Site Costs	2001

IFRS Sustainability Disclosure Standards

Title	Date issued	Effective date
IFRS S1 — General Requirements for Disclosure of Sustainability-related Financial Information	26 June 2023	1 January 2024
IFRS S2 — Climate-related Disclosures	26 June 2023	1 January 2024

IFRS Foundation. *IFRS - Home*. URL: http://www.ifrs.org.

IAS Plus. *IAS*. URL*: https://www.iasplus.com/en*

Articles - CPDbox - Making IFRS Easy. *CPDbox - Making IFRS Easy*. URL: https://www.cpdbox.com/articles/

Knowledge Base - IFRScommunity.com. *IFRScommunity.com*. URL: https://ifrscommunity.com/knowledge-base/

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