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Strategic Level

Advanced Financial Reporting FR3.3 Workbook

Institute of Certified Public Accountants of Rwanda
January 2026

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Overview of the Module

CPA level	Strategic level
Title	Advanced Financial Reporting
Guided learning hours	140
Exam length	3 hrs

Introduction to the Module

The Strategic Level Advanced Financial Reporting syllabus builds on knowledge developed in Financial Reporting at the Operational Level. The syllabus emphasises both financial and non-financial reporting, and reflects the continuing movement towards a broader style of reporting in which non-financial measures of performance are gaining stakeholder importance.

The syllabus is divided into eight areas / parts, all of which have relevance to organisations in both the private and public sectors.

The first part of the syllabus requires candidates to understand the relevance of ethical behaviour to financial reporting, the importance of developing a culture of compliance and the ethical responsibilities of a Certified Public Accountant in relation to stakeholders of an organisation. It requires that students can identify and resolve ethical dilemmas that emerge as a result of the application or non-application of principles within IFRS Standards and understand the consequences of failing to uphold ethical principles.

The second part of the syllabus considers the financial reporting framework in the private and public sectors. Candidates are required to understand the wider context in which financial reporting is set including the legal environment, governance best practice and other sources of regulation. They should appreciate the process by which accounting standards are developed and updated and the role of international and Rwandan bodies in this process. This area of the syllabus also includes the Conceptual Framework which candidates should be able to apply in order to develop accounting policies and critique accounting standards.

The third part of the syllabus requires candidates to prepare both financial and non-financial information in order to meet the needs of stakeholders. This information includes year-end and interim financial statements with associated disclosures as well as narrative reports dealing with environmental, social and governance issues. Candidates must appreciate the move towards a more holistic style of reporting including sustainability and integrated reporting, and be able to relate these developments to the needs of users.

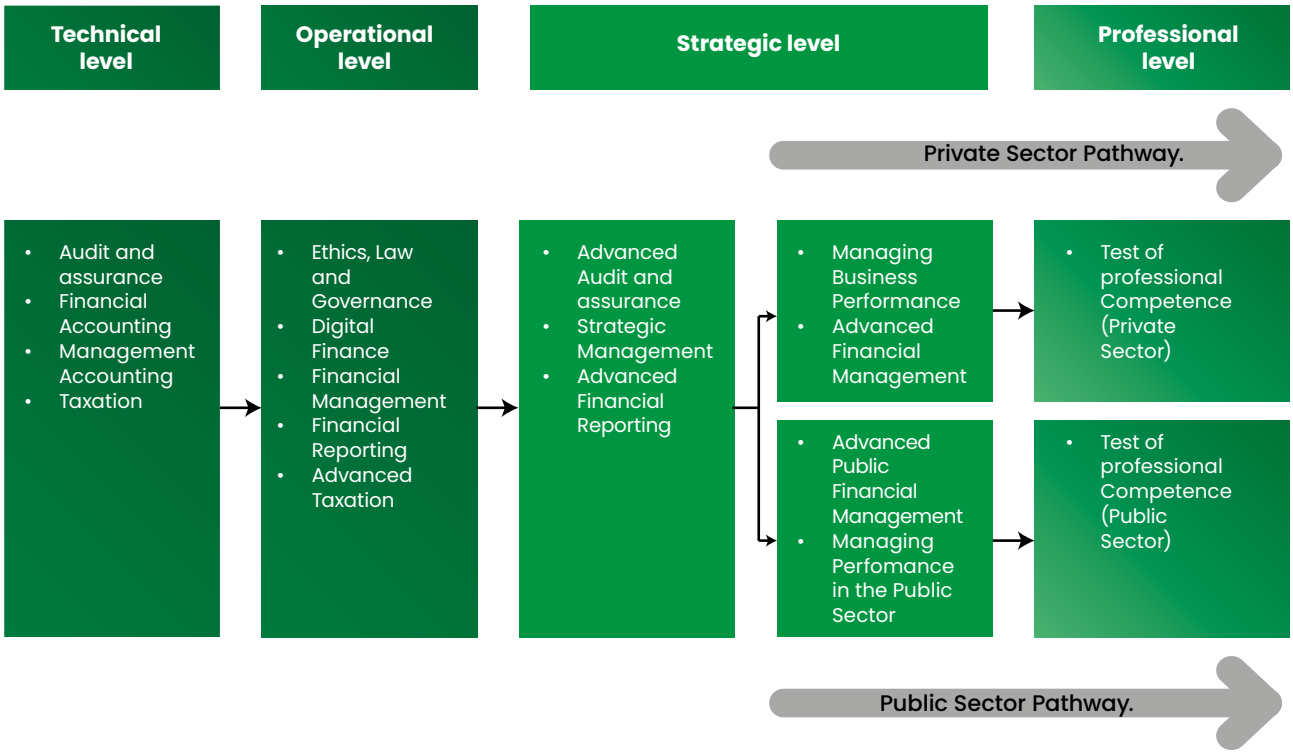
The fourth part of the syllabus deals with financial reporting issues. At this level, candidates must have an in-depth grasp of the major accounting standards; they must be able to develop appropriate accounting policies to apply to complex financial reporting issues, using their knowledge of accounting standards and the fundamental concepts and principles that underlie financial reporting.

The fifth part of the syllabus concentrates on group accounting procedures and requires candidates to be able to prepare consolidated financial statements for entities that have an interest in one or more domestic or international subsidiaries (controlled entities), associates and joint arrangements. Candidates must also be able to account for changes to group structures.

The sixth part of the syllabus focuses on analysis and interpretation. Candidates must be able to perform analysis of financial statements and other financial information, but also the wider information included in financial reports, including management performance measures and narrative information. The focus here is on reaching conclusions and making recommendations to stakeholders.

The final two parts of the syllabus relate to current issues and developments in financial reporting. In here, the seventh part of the syllabus requires candidates to identify issues in financial reporting and discuss solutions to them. These may relate to developments in accounting standards and narrative reporting guidance, or to the application of existing guidance to emerging issues. This section of the syllabus also includes first-time adoption of IFRS and accrual-based IPSAS. Finally, the eighth part of the syllabus considers the use of digital technology in financial reporting, and candidates must be able to discuss the application of such technologies in order to achieve more efficient and effective presentation of information.

This module is one of five completed at the strategic level of the CPA. Students will choose either the private sector pathway or the public sector pathway.



Key competencies

A. Evaluate the role of professional ethical behaviour in the private and public sector reporting environment, considering its role in the development of a culture of compliance and shared accountability.

B. Discuss and evaluate regulatory frameworks for financial reporting in the private and public sector.

C. Develop and present financial and non-financial information in order to provide a holistic view of an organisation's performance for relevant stakeholders.

D. Apply professional judgement in order to develop appropriate accounting policies for complex financial reporting issues in corporate entities and public sector organisations.

E. Prepare the financial statements of group entities.

F. Analyse and interpret financial and integrated reports, applying professional scepticism, and communicate the implications effectively to different stakeholders, recommending suitable decisions.

G. Critically discuss developments in financial reporting standards, regulations and business practices, assessing implications for the financial reporting function and business processes.

H. Discuss the application of digital technologies in accessing and analysing organisational reporting information, and in presenting this information as effectively as possible to stakeholders.

Unit A: Professional Ethics in Financial Reporting

Learning outcomes

A.1	Compliance and ethics in financial reporting

Introduction to Unit A

This first part of the syllabus requires candidates to understand the relevance of ethical behaviour to financial reporting, the importance of developing a culture of compliance and the ethical responsibilities of a Certified Public Accountant in relation to stakeholders of an organisation. It requires students to identify and resolve ethical dilemmas that emerge as a result of the application or non-application of principles within ethical standards, and understand the consequences of failing to uphold ethical principles.

The material in this Unit is drawn from the 2018 Handbook of the International Code of Ethics for Professional Accountants, issued by the International Ethics Standards Board for Accountants (IESBA). The Handbook (referred to throughout as the Code) is available on the ICPAR website at the following ***URL: Code of ethics – ICPAR – Institute of Certified Public Accountants Rwanda (icparwanda.com).***

As a professional accountant you are expected to be familiar with the Code itself, rather than with this workbook, in the same way that you will be required to be familiar with relevant accounting standards. For the purposes of the examination, however, the material provided here covers the scope of possible questions on professional ethics.

A.1 Compliance an ethics in financial reporting

1.1 The IESBA Code

The 2018 Handbook of the International Code of Ethics for Professional Accountants, issued by IESBA, provides the principal source of guidance for ICPAR members on ethical issues. Like the IASB, IESBA is an independent board supported by the International Federation of Accountants (IFAC), with its purpose being the development and promulgation of globally relevant standards on ethics. The Code adopts a principles-based approach, which means that it does not attempt to cover every situation where a professional accountant may encounter ethical issues and prescribe specific rules for each issue, primarily because these issues can arise in many different forms and contexts. Instead, the Code adopts a value system, focusing on fundamental principles that describe the objectives which a professional accountant should always seek to achieve.

The Code establishes a conceptual framework approach that should be applied by the professional accountant to manage ethical risks arising from their work. These risks comprise of threats to the fundamental principles and the Code requires the professional accountant to identify and classify circumstances where threats can arise, and put in place appropriate safeguards to address the threats. The ultimate safeguard for a professional accountant regarding any threat is to refuse to undertake the assignment. We will look in turn at the principles, threats and safeguards in the rest of this UNIT.

The Code provides separate application guidance based on whether the professional accountant works in business, or in public practice.

1.2 Definition of Types of Accountants

1.2.1 Accountant in Business

The definition of an Accountant in Business is as follows: a professional accountant working in such areas as commerce, industry, service, the public sector, education, the not-for-profit sector, regulatory bodies or professional bodies, who might be an employee, contractor, partner, director (executive or non-executive), owner, manager or volunteer.

1.2.2 Accountant in Public Practice

The definition of an Accountant in Public Practice is as follows: a professional accountant, in any functional classification such as tax, advisory or audit, working in a firm that provides professional services. Public practice does not refer to accountants in the public sector.

1.2.3 Comparison: Business vs Public Practice

While an Accountant in Business will primarily serve one client, their employer, an Accountant in Public Practice may be serving many clients simultaneously, including clients who are in competition with one another. While there are ethical issues common to both, the separation of these types of accountants in the Code reflects the fact that they will typically confront different types of ethical risk during their employment. A key aspect of professional employment in public practice is managing risks around clients – covering the appointment process, how the client pays for the service provided, and how the firm ensures that it provides an objective output, whether an audit opinion or performance study, that is not influenced by exogenous factors. Most large accounting and audit firms should have standard risk management procedures relating to client acceptance and continuance, which are periodically reviewed to determine whether circumstances may have changed.

For accountants in business, the risks primarily relate to being put under pressure to present misleading financial information, including being asked to undertake tasks for which we are not fully competent. As professional accountants in business, one of our key responsibilities is compliance with financial management and reporting requirements, and hence the importance of managing pressure put upon us to ignore breaches to the fundamental principles.

1.3 The Fundamental Principles

The five fundamental ethical principles, which must be always complied with by professional accountants, are as follows:

Integrity – the obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

The Code highlights the specific risks to this principle which arise from the role of accountants in producing information which may:

a) Contain a false or misleading statement;

b) Contain statements or information furnished recklessly; or

c) Omit or obscure information required to be included where such omission or obscurity would be misleading.

When a professional accountant becomes aware that they have been associated with such information they shall take steps to be disassociated from the information.

Objectivity – the obligation to exercise professional or business judgement without being compromised by:

a) Bias;

b) Conflict of interest; or

c) Undue influence of, or undue reliance on, individuals, organisations, technology or other factors.

Conflicts of interest occur where the accountant is exposed to competing demands, and where meeting one demand is likely to lead to loss on the part of the other(s). The most likely conflict of interest to arise is between the accountant's own interest and the interest of their client or the general public.

A conflict of interest creates a threat to objectivity and may create threats to the other fundamental principles. Such threats may be created when:

a) The accountant undertakes a professional activity related to a particular matter for two or more parties whose interests with respect to that matter are in conflict; or

b) The interests of the accountant with respect to a particular matter and the interests of a party for whom the accountant undertakes a professional activity related to that matter are in conflict.

A party might include an employing organisation, a vendor, a customer, a lender, a shareholder, or another party.

Professional Competence and Due Care – the obligation to:

a) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and relevant legislation; and

b) Act diligently and in accordance with applicable technical and professional standards.

Professional competence is first acquired or attained through the completion of the Professional Qualification and the ICPAR portfolio recording professional attainment for members. Competence is subsequently maintained through a robust, monitored scheme for Continuous Professional Development, to which you will become subject following your qualification.

Professional accountants shall, in addition, take reasonable steps to ensure that those working under their authority in a professional capacity have appropriate training and supervision.

A common circumstance where this principle can be threatened is where the professional accountant is asked to undertake an assignment for which they lack adequate experience. You should therefore be alert in ethics questions for references to trainees or recently qualified accountants being asked to undertake complex activities, as this will usually signal that professional competence and due care is under threat.

Confidentiality – the obligation to respect the confidentiality of information acquired as a result of professional and business relationships.

The primary requirement is not to disclose any client-related information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Third parties here may include your own colleagues, i.e. employees of an accounting firm who have not been assigned to that specific client. The need to comply with the principle of confidentiality continues even after the end of relationships between the accountant and a client or employer. When the accountant changes employment or acquires a new client, they are entitled to use prior experience. They shall not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

Notwithstanding these requirements, the following are circumstances where a professional accountant may be required to disclose confidential information or when such disclosure may be appropriate:

a) where disclosure is required by law, and is authorised by the client or the employer (or any other person to whom an obligation of confidence is owed) for Example:
    - production of documents or other provision of evidence in the course of legal proceedings or
    - disclosure to the appropriate public authorities (for Example, the Revenue Authority) of infringements of the law that come to light
    - disclosure of actual or suspected money laundering or terrorist financing to the firm's Money Laundering Reporting Officer or to the relevant authority directly, if the accountant is a sole practitioner, or

b) where there is a professional duty or right to disclose, which is in the public interest, and is not prohibited by law. Examples may include:
    - to comply with the quality review of an IFAC member body or other relevant professional body
    - to respond to an inquiry or investigation by ICPAR or a relevant regulatory or professional body
    - to protect the accountant's professional interests in legal proceedings
    - to comply with technical and professional standards including ethical requirements.

Professional Behaviour – the obligation to:

a) Comply with relevant laws and regulations;

b) Behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships; and

c) Avoid any conduct that the professional accountant knows or should know might discredit the profession.

Risks around professional behaviour will most likely to focus on compliance with laws and regulations, and this can be challenging depending on the complexity of the regulatory environment in which the accountant is operating. It is imperative that the professional accountant is fully aware of all such requirements.

More broadly, the principle of professional behaviour requires the professional accountant to not knowingly engage in any "business, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession." The Code, in other words, makes each professional accountant responsible for the reputation of all accountants. Furthermore, the Code specifically prescribes professional accountants from unethical marketing activities, whether this involves making exaggerated claims for the services or expertise offered, or conversely, making disparaging remarks about competitors, or other accounting firms.

1.4 The Conceptual Framework

1.4.1 Introduction

The conceptual framework provides a mechanism by which accountants are able to assess and manage ethical risks. Professional accountants are required to apply the conceptual framework to enable them:

- To **identify threats** to compliance with the fundamental principles,
- To **evaluate the significance** of such threats and, if they are not clearly insignificant,
- To **apply safeguards** to eliminate them or reduce them to an acceptable level, so that compliance with the fundamental principles is not compromised.

The Code requires the professional accountant to continuously monitor the ethical aspects of an engagement in order to identify threats that may arise as circumstances change. The conceptual framework helps us manage threats that have been identified, firstly by evaluating whether these threats are significant (acceptable) or not, and secondly, by identifying appropriate safeguards to reduce or eliminate the risk. 1.4.2 Applying the conceptual framework

The Code highlights some key considerations in the proper application of the conceptual framework when managing ethical issues.

1.4.3 Having an enquiring mind

An enquiring mind is a prerequisite to obtaining a sufficient understanding of the facts and circumstances necessary for the proper application of the conceptual framework to a particular situation. This involves consideration of the source, relevance and sufficiency of information used to evaluate the ethical issue at hand, and requires the accountant to remain open and alert to the possibility that further investigation or action may be needed.

1.4.4 Exercising professional judgement

The exercise of professional judgement is the foundation of the conceptual framework for addressing ethical issues. It involves the application of relevant training, professional

knowledge, skill and experience commensurate with the facts and circumstances, taking into account the nature and scope of the accounting activities and the interests and relationships involved.

In making this determination, the accountant should consider whether

a) Their expertise and experience are sufficient to reach a conclusion.

b) There is a need to consult others with relevant expertise and experience.

c) The accountant is subject to bias or preconception which limits their ability to exercise professional judgement.

1.4.5 Using the reasonable and informed third party test

The reasonable and informed third party test is a mechanism to test bias on the part of the professional accountant in applying the conceptual framework. It essentially involves consideration of whether a reasonable and informed third party would agree with the conclusions reached by the accountant, given the facts and circumstances known at the time the conclusion was reached. The reasonable and informed third party does not need to be an accountant, but would possess the relevant knowledge and experience necessary to impartially evaluate whether the accountant's conclusions were appropriate. This test represents an application of the broader accounting principle of "substance over form": even if you know that you are not exposed to ethical risk because you have not been influenced by a gift or a threat, for Example, a third party would be likely to assume that the gift or threat had an effect.

1.5 Threats to the fundamental principles

1.5.1 Classification of threats

Threats apply to the fundamental principles and may be created by a broad range of facts and circumstances that can change over the course of an engagement or activity. It is important to remember that a circumstance may give rise to more than one threat, and one threat may affect compliance with more than one fundamental principle. Threats fall into the following categories:

Self-interest threats may occur where a financial or other interest will inappropriately influence the accountant's judgment or behaviour, for Example:

- An accountant who holds a financial interest in, or receives a loan or guarantee from, the employing organisation. Note that this threat arises wherever accountants receive share-based remuneration, which is a very common mechanism for rewarding executives in listed companies
- A professional accountant who participates in incentive-based schemes for compensation, for Example, receiving a bonus for quickly preparing the annual financial statements.
- A professional accountant who is offered a gift by a major supplier to their employing organisation, particularly if the accountant has any role in the procurement of goods or services from that supplier, from drafting specifications to awarding contracts.

Self-review threats may occur when a previous judgement needs to be re-evaluated by the accountant responsible for that judgement. While this risk tends to arise most often in audit related activities, accountants in business must still be alert to them. For Example,

an accountant may be reviewing the valuation of fixed assets and discover that they made an error the prior year in calculating an impairment charge. While the Objectivity principle would guide them to correct the valuation, this might expose their error and damage their career prospects.

Advocacy threats may occur when an accountant promotes a position or opinion to the point that subsequent objectivity may be compromised. Advocacy threats will often arise where accountants in public practice are required to sell their services, perhaps by exaggerating the quality of their firm's work, or making unrealistic claims about undertaking assignments quickly or cheaply.

Familiarity threats may occur when, because of a close or personal relationship, an accountant becomes too sympathetic to the interests of others. This type of threat is more likely to arise for accountants in public practice, who may become too close to their clients and thereby fail to remain fully objective. This threat is the reason that corporate governance and auditing standards generally mandate rotation of external auditors on a periodic basis.

Intimidation threats may occur when an accountant is deterred from acting objectively by threats, whether actual or perceived. This type of threat can arise in almost any circumstance. Accountants in public practice may be intimidated by audit clients who tell them they will take their business elsewhere if they are given a qualified audit certificate. Accountants in business whose managers receive a bonus based on specific financial metrics may be threatened with termination if the metrics are not manipulated in the manager's favour.

1.5.2 Evaluating Threats

Once a threat has been identified, it must be evaluated to determine whether it represents an acceptable risk, or one that needs to be mitigated. Evaluation requires professional judgement and is impacted by the nature and scope of the professional activity.

The evaluation of the level of a threat may be impacted by the environment within the employing organisation. This may include, for Example:

- Whether leadership stresses the importance of ethical behaviour and encourages staff to act ethically.
- Whether policies and procedures exist to enable employees to safely raise ethical issues with senior management.
- Whether robust systems for corporate oversight and internal control exist.
- The existence of policies on ethics and codes of conduct.

The Code advises accountants to consider seeking legal advice if they operate in an environment where unethical behaviour has occurred in the past or is expected to continue to occur. If an identified threat to the fundamental principles is determined to be at an unacceptable level the threat must be eliminated or reduced to an acceptable level. This is achieved by:

- Elimination the circumstances, including interests or relationships, that are creating the threat. This may include the accountant divesting themselves of specific investments or loans, for Example.
- Applying safeguards, where these are available and capable of being applied. The safeguards are discussed in more detail below.

Declining or ending the specific activity which gives rise to the threat: The ultimate sanction in the event of a threat that cannot be reduced to an acceptable level is to terminate the activity. This may include an audit firm refusing to audit a specific company, or an accountant resigning from employment which forces them to breach the Code of Ethics.

1.5.3 Safeguards

Safeguards are actions or other measures that individually, or in combination, reduce threats to an acceptable level. In order to demonstrate the application of the conceptual framework by the professional accountant, it is necessary to document the circumstances that give rise to specific threat(s) and any safeguards identified. On its own, documentation is unlikely to reduce threats to an acceptable level, and will normally be accompanied by other specific actions directed to the specific nature of the threat.

As a professional accountant, there are several general safeguards available which derive from the profession and relevant laws and regulations, such as:

- Educational, training and experience requirements for entry into the profession
- Continuing professional development requirements
- Corporate governance regulations
- Professional standards
- Professional or regulatory monitoring and disciplinary procedures
- External review of the reports, returns, communications or information produced by an accountant and carried out by a legally empowered third party.

These safeguards provide the professional accountant with the skills and capabilities to effectively utilise the conceptual framework by assessing situations in the light of the relevant standards and laws; or they establish mechanisms to encourage the accountant to apply the ethical principles consistently – e.g. disciplinary procedures and external review. There are a number of standard safeguards that may or may not be available from your employer. The larger the organisation, the more likely these safeguards may be available:

- The employer's system of corporate oversight or other oversight structures.
- The employer's specific ethics and conduct programmes.
- Recruitment procedures in the employer emphasising the importance of employing high calibre competent staff.
- Strong internal controls.
- Appropriate disciplinary processes.
- Leadership that stresses the importance of ethical behaviour and the expectation that employees will act in an ethical manner.
- Policies and procedures to implement and monitor the quality of employee performance.
- Timely communication of the employer's policies and procedures, including any changes to them, to all employees and appropriate training and education on such policies and procedures.

- Policies and procedures to empower and encourage employees to communicate to senior levels any ethical issues that concern them without fear of retribution.
- Consultation with another appropriate professional.

When evaluating a threat to the fundamental principles it is important that these safeguards are individually assessed, as they may be more helpful in some circumstances than others. Some of these safeguards are primarily preventative, such as the existence of strong internal controls and strict recruitment criteria. These safeguards should reduce the likelihood of ethical threats arising. The existence within the employer of strong ethical leadership and whistle-blowing mechanisms, on the other hand, are helpful when an ethical issue has arisen and the accountant needs guidance on the best course of action. **Exam-tip:** When assessing ethical issues in questions, you should look carefully for information about the size and sophistication of the employer, specifically in respect to corporate culture and ethical leadership ("the tone at the top"). Where you see reference to a large, or mid-size firm of accountants, for Example, you should expect that access to almost all the institutional safeguards mentioned will be available. Conversely, an accountant who is a sole practitioner, or works in a small charity (with non- accountants who may not understand ethics for professional accountants), may have very limited options for safeguards available.

As a general rule, where internal safeguards such as whistle-blowing hotlines or a designated ethics partner are in place, the professional accountant should utilise these mechanisms before considering taking advice or engaging with third parties. External safeguards which provide anonymity, and are sensitive to the issues involved, such as a helpline operated by ICPAR, would be the next best source of advice. It may be important for an accountant to seek for legal advice prior to engaging with a third party over a resolution of an ethical threat.

Summary of Unit A and key learning outcomes

In this unit, we looked at the following learning outcome:

Learning outcome	
Professional ethics in financial reporting	You should now be able to describe the five fundamental ethical principles and the five threats to which the principles can be exposed, in addition to being able to identify common safeguards. You should also be able to describe the conceptual framework and how it is applied by professional accountants in either business or public practice.

To summarise, when confronting an ethical issue, the professional accountant should follow these steps in evaluating threats and identifying safeguards:

- Obtain information about the relevant facts
- Identify the ethical issues involved
- Identify the relevant fundamental principles
- Identify whether any internal procedures exist that could address the issues
- Identify whether alternative courses of action are available
- Document the process followed and factors considered in determining the most appropriate course of action

Once this information has been obtained, the accountant should consider the consequences of the different courses of action available, based on those facts. Accountants at this point should also consider whether reporting the issue to those charged with governance will help (e.g. the Board of Directors, or Audit Committee or any similar internal organ), which will depend on the nature of the threat.

If these courses of action do not resolve the issue, and internal resources have been exhausted without assisting sufficiently, the accountant should seek advice from ICPAR, typically anonymously, after obtaining legal counsel. Consulting with lawyers is a very serious step that should not normally be taken where other options exist.

The last and most extreme safeguard to apply under the Code is to withdraw from the engagement or resign from the employment that is threatening the accountant's ethical principles.

Quiz questions

Scenario:

You are a professional accountant in the accounting services function of a large audit and accounting firm who has recently applied for a manager's position. Your team has been assisting a large audit client of the firm with resolving issues relating to bank reconciliations. During the course of your work, you have identified that historic bank balances have been mis-stated due to a number of significant systematic weaknesses in internal controls. The financial statements which include these mis-statements were audited by your firm and do not identify any issues with bank balances or internal controls.

Due to the significance of this client, the managing partner of the firm is the lead engagement partner.

Unit B: Regulatory Frameworks for Financial Reporting

Learning outcomes

B.1	Financial reporting framework in the private sector
B.2	Financial reporting framework in the public sector

Introduction to Unit B

In the earlier paper for Financial Reporting, you were introduced to the International Accounting Standards Board (IASB) and the International Public Sector Accounting Standards Board (IPSASB), as well as to their respective conceptual frameworks. As a professional accountant you are required to keep up to date with developments in your field and this is formalised by your obligation to ensure that you undergo a defined minimum quantity of Continuing Professional Development (CPD) time each year. Understanding the context within which these developments occur is important to your ability to navigate changes successfully, and to anticipate changes that are coming into view. Hence this unit expands on the exploration of the regulatory context for both IFRS and IPSAS that you completed in the Financial Reporting paper. The goal is to provide you with a comprehensive understanding of how the main accounting regulatory boards operate, how they develop standards, and what the key differences are between them.

B.1 Financial reporting framework in the private sector

1.1 IFRS Strategy and Themes

A significant focus of development in private sector financial reporting is the increasing recognition of the importance of aligning financial and non-financial information, particularly in relation to sustainability, to improve the quality of information available to users of financial statements. The IFRS Foundation 2023 Annual Report, for Example, describes the recent development of IFRS Sustainability Disclosure Standards as fundamental "to the role of transparent and comparable accounting and sustainability-related information in the world's capital markets" and states that together the accounting and sustainability standards "support efficient capital allocation by helping investors to identify opportunities and risks globally." The new sustainability standards are not an "optional extra" in other words, but are an essential component of how the IASB defines effective financial reporting, and this represents a significant change, and potential challenge, for accountants to address.

The IFRS Foundation 2023 report summarises key accomplishments and progress in 2023, including:

- The International Accounting Standards Board (IASB) completing the decision-making on two new IFRS Accounting Standards—IFRS 18 Presentation and Disclosure

in Financial Statements and the forthcoming IFRS 19 Subsidiaries without Public Accountability: Disclosures;

- The International Sustainability Standards Board (ISSB) launching its inaugural IFRS Sustainability Disclosure Standards—IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures—providing a global baseline of sustainability-related disclosures aimed at the capital markets; and
- The Foundation expanding its global operations with the opening of a new office in Beijing and renewed support for its office in Tokyo to facilitate engagement with stakeholders.

The Foundation's priorities planned for 2024 included:

- Finalising decisions on key projects including the third edition of the IASB's IFRS for SMEs Accounting Standard and starting new projects on intangible assets and Statement of Cash Flows;
- Supporting implementation of IFRS Sustainability Disclosure Standards and finalising the ISSB's future work plan; and
- Engaging with regulators and other authorities on the adoption of IFRS Standards and with companies, investors and other capital market stakeholders on their use of the Standards.

1.2 IFRS 18 Presentation and Disclosure in Financial Statements

The objective of IFRS 18 is to set out requirements for the presentation and disclosure of information in general purpose financial statements to help ensure they provide relevant information that faithfully represents an entity's assets, liabilities, equity, income and expenses. IFRS 18 thus represents an update of IAS1, and has a significant impact on the preparers of financial statements.

IFRS 18 requires companies to classify all items of income and expenses on the face of the Statement of Profit or Loss into one of the following five categories:

- Operating
- Investing
- Financing
- Income taxes; and
- Discontinued operations

The first three categories are new to the Statement of Profit or Loss presentation, but should be familiar to you from the structure of the Statement of Cash Flows. IFRS 18 provides specific guidance to assist preparers in identifying items to be classified in each respective category especially for companies with specified main business activities of investing in assets or providing finance to customers. The guidance appears to follow that provided for the classification of cash flows, based on the nature of the business. So, for Example, a bank's operating income and expenditure will include trades in financial assets and liabilities that would fall under financing or investing activities for a non-banking company.

The new categories are complemented by the new requirements to present subtotals and totals for "operating profit or loss," "profit or loss before financing and income taxes"

and "profit or loss", helping make clear the contribution of the different categories to the company bottom line.

The new standard also defines rules for aggregation and disaggregation of items on the face of the Statement of Profit or Loss based on shared characteristics, or their absence.

Another important feature of IFRS 18 is the management-defined performance measures (MPMs). An MPM is a subtotal of income and expenses not listed in IFRS accounting standards, nor specifically required to be presented or disclosed by an IFRS accounting standard. Companies use MPMs in public communications outside financial statements to communicate to users the management's view of an aspect of the financial performance of the company as a whole.

An Example of a widely used MPM is EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation) which represents a variant on operating profit, less accounting adjustments which do not have cash flow implications. The goal of IFRS 18 is to enhance the comparability of MPMs by requiring disclosure of all MPMs in a single note to the financial statements. It also requires disclosure of how the measure is calculated, how it provides useful information to users, and a reconciliation to the most comparable subtotal specified by IFRS accounting standards.

IFRS 18 is effective for annual reporting periods beginning on or after 1 January 2027, and is to be applied retrospectively for comparative periods.

1.3 IFRS 19 Subsidiaries without Public Accountability: Disclosures

The objective of IFRS 19 is to specify the disclosure requirements an entity is permitted to apply instead of the disclosure requirements in other IFRS Accounting Standards. It provides, in other words, a set of discrete disclosure requirements that certain companies may apply, rather than having to follow the disclosure requirements included in each individual IFRS standard.

A company that wishes to apply IFRS19 must meet the following criteria:

- It is a subsidiary
- It does not have public accountability; and
- It has an ultimate or intermediate parent that produces consolidated financial statements available for public use that comply with IFRS Accounting Standards.

An entity has public accountability if:

- Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
- It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (for Example, banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks often meet this criterion). So publicly traded/listed companies, and banks and providers of financial services, have public accountability and cannot apply IFRS 19. All other companies can, as long as they are subsidiaries whose ultimate parent reports using full IFRS.

This standard essentially simplifies the disclosures of subsidiary companies on the basis that the subsidiary financial statements are merely a component of the parent financial statement, and the parent is required to present all the relevant disclosures for all its material components in its consolidated financial reports.

IFRS 19 is effective for reporting periods beginning on or after 1 January 2027.

1.4 IFRS Sustainability Disclosure Standards

Key drivers that led the IFRS Foundation to establish the ISSB include the need:

- To address the proliferation of voluntary initiatives in the sustainability disclosure landscape;
- To ensure that investors receive high-quality, comparable information about sustainability-related risks and opportunities; and
- To enable companies to provide such information to their investors efficiently.

The ISSB's goal has been to reduce the complexity of multiple sources of sustainability reporting initiatives, while building on the established expertise and practice associated with the IFRS frameworks and standards.

The creation of the ISSB involved the consolidation of the Climate Disclosure Standards Board (CDSB), Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) with the IFRS Foundation. Furthermore, the Task Force on Climate-related Financial Disclosures was disbanded following publication of the ISSB's inaugural Standards:

- IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and
- IFRS S2 *Climate-related Disclosures*.

The ISSB works closely with the body that brings together international securities regulators—the International Organization of Securities Commissions—as well as directly with jurisdictions, including through its Jurisdictional Working Group to support steps towards the use of the ISSB Standards. More than 20 jurisdictions have already decided to use or are taking steps to introduce ISSB Standards in their legal or regulatory frameworks. Together, these jurisdictions account for nearly 55% of global gross domestic product and more than 40% of global market capitalisation.

We will look in more detail at the new sustainability standards in Unit G.

1.5 Principle vs Rule Based Accounting Frameworks

While many countries have adopted IFRS, there are other accounting frameworks in use around the world that you may, as a professional accountant, be exposed to through your future career, especially if you work for a multinational company. One key aspect of IFRS that should be appreciated is the essential approach that is taken to establishing rules for accounting and reporting. In practice there are two main approaches to developing frameworks of rules: the principle-based approach, or the rules-based approach. IFRS (and IPSAS) uses the principle-based approach, which means that the standards provide a framework that should be applied to accounting activities and the application process should be explained in the financial statements. The rules-based approach, on the other hand, provides very detailed rules for everything which must be followed precisely, in turn reducing the need for explanatory disclosures.

The fundamental advantage of principles-based accounting is that its broad guidelines can be applied in a variety of circumstances, and the accounting and reporting treatment can thus be made to fit operational requirements. Precise rules can sometimes compel managers to manipulate the financial statements to fit what is compulsory, because

changing systems and processes to properly comply with the rules is too demanding or resource intensive.

On the other hand, when there are strict rules that need to be followed the possibility of lawsuits is diminished because management have less freedom to make decisions which could be subject to legal action. Having a set of rules can also increase accuracy and reduce the ambiguity that management can use to obscure financial manipulation.

US GAAP is probably the rules-based framework for accounting (supplemented by additional rules for publicly traded companies) that you may most likely to encounter with in your work. The key application differences between US GAAP and the IFRS GAAP are as follows:

Area	Difference
Inventory	IFRS bans the use of last-in, first-out (LIFO) inventory accounting methods. US GAAP rules allow for LIFO. Both systems allow for the first-in, first-out method (FIFO) and the weighted average-cost method.
Investments	The main differences come in recognising income or profits from an investment. Under the US GAAP, it is largely dependent on the legal form of the asset or contract. Under the IFRS GAAP, the legal form is irrelevant and only depends on when cash flows are received.
Research and Development	Under the US GAAP and IFRS GAAP, Research and Development expenses are booked as they occur. However, IFRS also requires certain Research and Development expenditures to be capitalised (e.g. some internal costs like prototyping).

B.2 Financial reporting framework in the public sector

2.1 The IPSASB

While private sector companies are generally required to follow an appropriate accounting framework, such as the IFRS GAAP or US GAAP, to operate legally, governments can choose whether or not to adopt a specific framework. Several countries have used IPSAS as the basis for developing national standards, such as South Africa's Generally Recognised Accounting Practice, and the European Union has also used IPSAS in developing European Public Sector Accounting Standards. Not all such projects have met expectations however, with requirements around consolidation of the wider public sector presenting apparently insurmountable difficulties to some countries' full implementation of IPSAS related frameworks.

Hence the IPSASB needs to be seen to have a credible process for developing standards, including sufficient representation from developing countries, if IPSAS are to achieve widespread acceptance and adoption. The IPSASB claims to follow an open and transparent due process to ensure that IPSAS are developed in the public interest.

2.2 The IPSASB Consultative Advisory Group

The IPSASB established the Consultative Advisory Group (CAG) following a governance review in2014. The objective of the CAG is to provide a forum where the IPSASB consults representatives of public and private sector organisations, or individuals, that are interested in or affected by its work. These representatives then provide IPSASB with:

- Advice on the IPSASB's strategy, work program and agenda, including project priorities;
- Advice on projects, including views on key technical issues or matters that may impede the adoption or effective implementation of IPSASs; and
- Advice on other matters of relevance to the standard-setting activities of the IPSASB.

According to IPSASB, the membership of the CAG should provide, to the extent practicable, a balance of geographical representation and between regulators, auditors and professional accounting bodies, international organisations, users and representatives of governments and other public sector entities, including preparers. The membership list currently comprises 26 members drawn from around the world, with most representing government ministries and agencies, but several others representing special interest groups and multilateral bodies like the world bank.

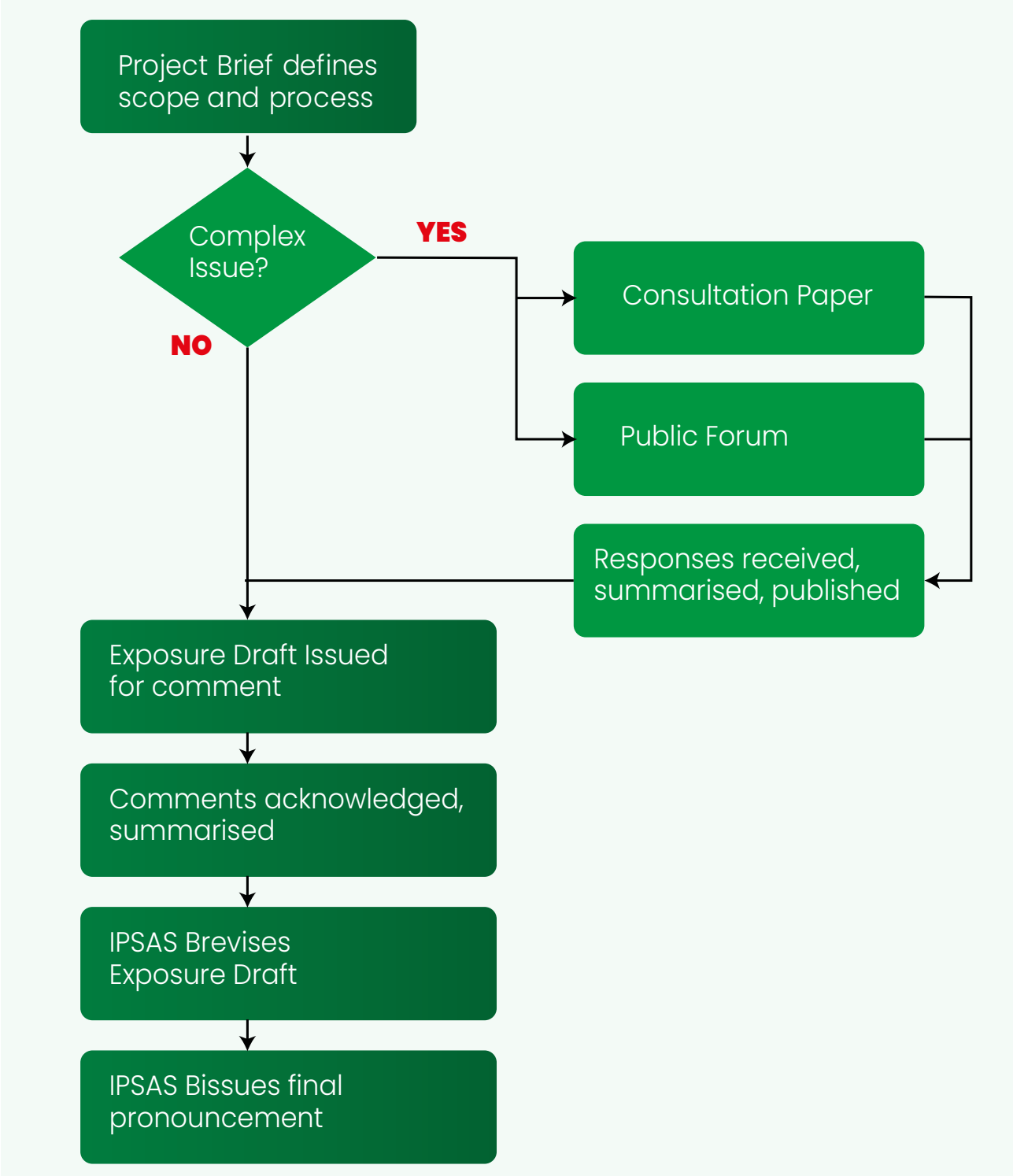
2.3 The IPSASB standard setting process

In developing IPSAS, the IPSASB must adhere to a process set and agreed with the Public Interest Committee (PIC). The IPSASB provides the PIC with documents for all new or revised IPSAS before their release and show how the due process has been followed. The PIC may require the IPSASB to take further steps to address any concerns regarding the application of due process, if raised.

In setting its strategy and work plan, the IPSASB also obtains the PIC's advice on the work plan, and on the completeness of the strategy and work plan from a public interest perspective. The IPSASB also discusses progress on its strategy and work plan with the PIC on a regular basis.

There is an established process for developing IPSAS and Recommended Practice Guidelines (RPGs).

The strategy and workplan developed in consultation with the users and preparers globally following comprehensive awareness and engagement event, set out the plans for future IPSAS.



IPSASB staff develop a project brief to determine the scope of a particular project, and the type of process that will be followed in developing the related standard or RPG.

The type of process to be followed includes consideration of whether a Consultation Paper should be issued, or a public forum scheduled. A public forum may be needed where there is potential controversy or significance. The responses received through the initial consultation process are summarised and published by the IPSASB to ensure transparency.

The IPSASB issues exposure drafts (ED) of all proposed IPSASs and RPGs for public comment. Exposure Drafts follow the format of a standard or RPG but include additional explanatory material. Exposure Drafts are reviewed internally, and their issue is approved by the IPSASB before they are circulated for comment.

Exposure Drafts provide all those affected by IPSASB pronouncements with the opportunity to present their views before the pronouncements are finalised and approved. The IPSASB considers all comments received on Consultation Papers and exposure drafts in developing an IPSAS or RPG. The comment or exposure period for an Exposure Draft is usually 120 days, but this may be longer or shorter based on the perceived complexity or controversy related to the project.

Anyone may comment on Exposure Drafts, but most accounting institutes and other key stakeholders will establish formal processes of their own to ensure that they provide comprehensive comment to the IPSASB.

Following receipt of comments, the IPSASB will respond to all contributors and summarise the various issues raised to determine whether changes are needed to the Exposure Draft.

Once these changes have been made, in consultation with the CAG and other relevant stakeholders, the final standard or RPG will be formally issued, to become effective on the dates stipulated in the pronouncement. A basis for conclusions is also published, which includes any differing views of IPSASB members, public comments and the steps taken in the due process. 2.4 Interaction with National Standard Setters and the IASB

The IPSASB cooperates with national standard setters in preparing and issuing IPSASs and RPGs, with a view to sharing resources, minimising duplication of effort and reaching consensus and convergence in standards at an early stage in their development. It also promotes the endorsement of IPSASs and RPGs by national standard setters and other authoritative bodies and encourages consultation with users, including elected and appointed representatives, Treasuries, Ministries of Finance and similar authoritative bodies, and practitioners throughout the world to identify user needs for new standards and guidance.

In developing its pronouncements, the IPSASB seeks input from the CAG and considers and makes use of pronouncements issued by:

- The International Accounting Standards Board to the extent they are applicable to the public sector;
- National standard setters, regulatory authorities and other authoritative bodies;
- International organisations responsible for the development of statistical bases of financial reporting;
- Professional accountancy organisations; and
- Other organisations interested in financial reporting in the public sector.

More broadly, IPSASB develops accrual standards that:

- Are converged with International Financial Reporting Standards by adapting them to a public sector context when appropriate. IPSASB tries to maintain the same accounting treatment wherever possible unless there is a significant public sector issue which warrants a departure; and
- Deal with public sector financial reporting issues that are either not comprehensively or appropriately dealt within existing IFRSs or for which IFRSs have not been developed by the IASB.

Broadly speaking, IPSAS standards have now been almost completely aligned with their respective IFRS equivalent (with a few notable and necessary exceptions, such as non-exchange revenue) and future developments of IPSAS may thus be dominated, if not exclusively, by the process of following developments in IFRS. As a result, for professional accountants, widespread adoption of IPSAS presents us with more career options, and allows us the ability to move quite easily between financial roles in the private and public sector. It also aids comparability between private and public and between different countries that are using IPSAS.

2.5 Further consideration of conceptual frameworks

2.5.1 The IPSAS Conceptual Framework

The *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* is an important document. It sets out the guiding principles for developing International Public Sector Accounting Standards and Recommended Practice Guidelines (RPG). It provides a structure for standards and ensures these interact consistently, and imposes accountability on standard setters by requiring them to be transparent about the development process and explain any deviations. It does this by establishing key principles, such as whether a certain valuation method can be applied, that are then integrated consistently as standards and other guidance is developed.

The Conceptual Framework does not override established IPSAS or RPGs. However, where there is no relevant standard, the Conceptual Framework sets out the concepts that preparers can use to help determine the definitions, recognition criteria and measurement principles.

The fact that the objective of public sector entities is not to make profits, but deliver services to the public, means that typical financial statement analysis into gross, operating and net profit is not appropriate. Governments generally have broad powers such as making and enforcing laws, and this includes defining the way that public finances are managed. Hence the IPSAS Conceptual Framework is a very important tool to enable countries to shape their public sector accounting and reporting in a manner that hopefully aligns local laws with international standards.

2.5.2 The role of General-Purpose Financial Reports

The role of General-Purpose Financial Reports (GPFR) is wider than financial statements in the private sector context, as citizens are dependent on government and public sector entities deliver a wide range of public services, on an ongoing basis, some of which are long term in nature. In jurisdictions that practice regular elections, government performance in delivering these services and supporting dependent citizens is likely to be a major factor in electoral success. It therefore makes sense for governments to provide a broader range of information about its responsibilities to match the wider information needs of its users. This information is reported in GPFRs.

The Conceptual Framework defines GPFR as:

- Intended to meet information needs and not designed for specific users' needs;
- Likely to include numerous reports, for Example, linking to objectives. Notes to the GPFRs include further information and should be presented in a way to enhance, complement and/or supplement the financial statements; and
- The scope of financial reports is determined by the information needs of the users.

The Conceptual Framework is applicable to government departments, ministries, programmes, Boards, commissions, agencies, and other entities that are public sector in nature.

2.5.3 Users of GPFRs

The standards often refer to the users of the financial statements. The Conceptual Framework defines this term as follows: primary user groups are

- service recipients and
- resource providers

The two terms are used consistently throughout and can be taken as referring primarily to people who pay taxes and people who utilise government services. Essentially everyone living in a country is likely to fall under this definition. Indeed, we may think that primary users are citizens, but funding can also be given by donors and lenders, and so foreigners can be added to the user list as well.

The legislature is often considered a primary user of the GPFRs since most countries have an annual budget process where the representatives of the public approve a law authorising the next year's government expenditure. At year end the legislature or one of its committees will usually formally accept a budget out-turn, which is a statement showing the expenditure alongside the approved budget. GPFRs will usually include a budget out-turn, indeed it is a requirement of IPSAS 24.

Interestingly, users are assumed to have reasonable knowledge of the entity's activities/ environment and be able to read GPFRs, as well as to review and analyse the information with reasonable diligence. Many complain that the financial statements are impenetrable for users to be able to digest the information. However, the Conceptual Framework states that relevant information does not have to be excluded simply because it is seen to be too complex. Arguably, the scope and range of public sector services is complex, hence it follows that the resulting accounting will be complex too.

2.5.4 Comparison of IASB/IPSASB Conceptual Frameworks

The IASB Conceptual Framework has applied a hierarchy to the qualitative characteristics as follows:

Characteristic	Hierarchy
Relevance	Fundamental
Faithful representation	
Timeliness	Enhancing
Understandability	
Verifiability	
Comparability	

The division of characteristics by the IASB is intended to clarify that information which lacks relevance or fails to faithfully represent the underlying activity cannot meet the objectives of financial reporting, irrespective of how timely, or understandable it is.

The IPSASB does not separate the qualitative characteristics in a hierarchy, and considers them all to be equally significant. As a result, it also discusses how preparers of financial statements can balance the different characteristics with the goal of ensuring that the ultimate objective of financial reporting, providing useful information, can be met.

Both frameworks recognise that financial reporting is constrained by the cost of providing information versus the benefit obtained. The IPSASB in addition, recognises materiality as a constraint on financial reporting. This is because the wider range of content provided in GPFRs makes it difficult to mandate what is relatively important and the IPSASB conceptual framework therefore leaves it to preparers (and their auditors) to use their professional judgement and agree on whether a specific requirement can reasonably be overlooked based on it not being material.

Summary of Unit B and key learning outcomes

In this unit, we looked at the following learning outcome:

Learning outcome	
Regulatory frameworks for financial reporting in the private and public sector.	Building on the knowledge gained during Financial Reporting, you should now be able to discuss and evaluate key features of the IASB and IPSASB regulatory environment. You should also be able to explain the role of the two conceptual frameworks issued by the IASB and IPSASB and highlight their key differences.

Quiz questions

1.	B
The new ISSB Sustainability Standards can be best described as:	
A	Mandatory for all companies using IFRS
B	An option available for companies using IFRS to adopt
C	An essential component of accountability
D	Mandatory for publicly traded companies using IFRS

2.	B
The main benefit of using a principles-based approach to accounting is (choose one):	
A	The principles can be applied in a variety of operating settings
B	A principles-based approach reduces ambiguity
C	The principles are easier for accountants to properly apply than a set of complex rules
D	The principles can be applied to a wider range of accounting activity

3.	B
Which one of the following statements correctly describes the process for developing IPSAS standards:	
A	Consultation papers are published for each ED issued, but not for RPGs
B	The maximum period allowed for comment on an ED or RPG is 120 days
C	The PIC consults with stakeholders worldwide before it develops the IPSASB strategy
D	EDs are published to allow stakeholders the opportunity to comment before formal standards are issued

4.	**B**
The IPSASB interacts with other standard setting bodies in order to (choose one):	
A	Maximise the acceptability of IPSAS standards
B	Reduce the need to prepare IPSAS where other standards exist
C	Develop a consensus around issues common to different frameworks
D	Align IPSAS standards with statistical reporting frameworks

5.	**B**
Which one of the following statements about GPFRs is correct (choose one):	
A	GPFRs comprise financial statements and a budget out-turn
B	The scope of GPFRs is determined by users' needs
C	The users of GPFRs comprise tax payers and service recipients
D	GPFRs are intended to meet specific users' needs

6.	**B**
IPSASB includes materiality as a constraint in financial reporting because (choose one):	
A	Public sector accounting is more complex than private sector accounting
B	Public sector entities have limited resources to spend on financial accounting and reporting
C	Public sector accountants are less competent than private sector accountants
D	The scope of GPFRs is wider and this may result in normally material items being less important

Unit C: Development and Presentation of Financial and Non-Financial Information

Learning outcomes

C.1	Financial information
C.2	Disclosure of financial information in the public sector
C.3	Non-financial information

Introduction to Unit C

This unit takes a holistic view of company reporting by considering a number of interventions, originating largely but not entirely in the accounting profession, aimed at improving the quality of financial reporting. The overall goal of these various IAS and IPSAS standards, as well as other reporting frameworks we will look at, is to improve the links between financial and non-financial information, and hence the usefulness of company reporting more generally. The syllabus requires students to be able to discuss this content alongside relevant material from Financial Reporting, and it is important that when preparing for this exam, you refresh your knowledge of IFRS 5 and 18, and IAS 10 and 21 from the earlier paper on Financial Reporting.

Under financial information, we will first look at how to adjust financial reports when a company operates in a hyperinflationary environment, then turn to interim reporting, related parties and segment reporting. Each of these areas is explored by considering a specific IAS or IFRS that sets out the recognition, measurement and disclosure requirements to be applied to address the issues that arise in that context. We will then touch on the IPSAS requirements for budget reporting, segment reporting and reporting on the General Government Sector. The final section will then discuss developments in corporate reporting more generally that aim to improve the usefulness of company information.

C.1 Financial Information

1.1 Hyperinflationary Accounting

A hyperinflationary economy is one where the value of the currency of the country is rapidly losing purchasing power, and this means that the value of money held, gained and spent over the year will be different at the transaction date from the value at the reporting date. The principle is not dissimilar to that underpinning foreign currency transactions,

where value potentially changes based on factors beyond the entity's control. To assist companies in presenting financial information on a comparable and consistent basis in this context, IAS 29 was issued. The standard applies where an entity's functional currency is that of a hyperinflationary economy. The standard does not prescribe when hyperinflation arises but requires the financial statements (and corresponding figures for previous periods) of an entity with a functional currency that is hyperinflationary to be restated for the changes in the general pricing power of the functional currency.

The first step is thus to determine if the environment is hyperinflationary, and the second to identify a suitable index to use to adjust reported values.

1.1.1 Hyperinflation

The standard provides the following indicators as to whether a country might be hyperinflationary:

- The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency.
- Amounts of local currency held are immediately invested to maintain purchasing power;
- The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;
- Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;
- Interest rates, wages, and prices are linked to a price index; and
- The cumulative inflation rate over three years approaches, or exceeds, 100%

One of the key points is that money loses value in this context, but non-financial assets do not, so people quickly try to translate money into goods or other assets that will retain their value. Conversely, financial liabilities become cheaper to service under hyperinflation, meaning that losses in financial asset values can be mitigated by gains in the servicing of payables and debt. As we will see shortly, these factors determine how companies should account for hyperinflation in terms of their Statement of Financial Position.

1.1.2 Identifying an Index

To adjust financial statements to reflect a loss in purchasing power, an authoritative price index should be used. These indices are usually published by national statistical agencies, and the most recognised is the Consumer Price Index (CPI), which presents the changes in price that a basket of typical consumer goods has undergone in the reporting period. In Rwanda, the CPI is produced monthly by the National Institute of Statistics Rwanda. However, CPI relates to general consumer goods, and some companies may not find these appropriate based on the way their purchasing power is being impaired. Alternative indices are thus available in some environments, typically in developed countries with sophisticated statistical information and capacity. Alternative indices include those showing producer price changes and wholesale price changes.

In the absence of a reliable General Price Index (GPI), companies can also use the exchange rate or any other equivalent measure that reflects the changes in value that they are experiencing. Local sources of useful information could include the Ministry of Finance, the statistics department, Central Bank or any other reliable research publication.

External sources could include the IMF, World Bank and the Economic Intelligence Unit.

1.1.3 Applying IAS 29

IAS 29 requires companies to restate their financial statements if the functional currency they operate in is undergoing hyperinflation. The standard states that the financial statements of an entity whose functional currency is the currency of a hyperinflationary economy, whether they are based on a historical cost approach or a current cost approach, should be stated in terms of the measuring unit current at the end of the reporting period.

To restate a company's financial position, items on the financial statement are separated between monetary and non-monetary items. Shareholder's equity is treated slightly differently.

Monetary Items

Examples of monetary assets and liabilities are provided in the table below:

Monetary Assets	Monetary Liabilities
Trade and other receivables	Trade and other payables
Cash and cash equivalents	Provisions
Investments in listed equity investments (financial assets)	Borrowings
	Lease liabilities

These items are **not** restated, as they reflect the purchasing power at the end of the period, since the absolute value stays the same.

Index linked assets and liabilities have to only be adjusted in accordance to contractual terms and not the General Price Index.

Non-Monetary Items

Examples of non-monetary assets are as follows:

- Investment in subsidiaries
- Prepayments
- Right of use of asset

Non-monetary assets and liabilities at current cost are **not** restated.

Non-monetary assets and liabilities at historical costs are restated.

Items held at current cost should reflect current values, and hence do not need to be restated.

Shareholder's Equity

At the beginning of the first period when IAS 29 is applied, the components of shareholders' equity, excluding retained earnings and any revaluation surplus, are restated by applying a general price index from the dates on which the items were contributed or otherwise arose. This includes reserves created by amounts recognised in other comprehensive

income. Any revaluation surplus that arose in previous periods is eliminated. Retained earnings are restated for the balancing figure derived from the other amounts in the restated opening Statement of Financial Position.

At the end of the first period and in subsequent periods, all components of shareholders' equity are restated by applying a general price index from the beginning of the period or the date of contribution, if later. The movements for the period in shareholders' equity are disclosed in accordance with IFRS 18.

Restatement Formula

The formula to apply when restating values on the statement of financial position under IAS 29 recalculates the net book value of the item by multiplying its historical cost value by the appropriate index value, which is the difference between inflation at acquisition and at the reporting date:

$$\textbf{Restated NBV} = \text{Historical Cost} \times \frac{\text{GPI at reporting date}}{\text{GPI at acquisition date}}$$

The formula for the Statement of Profit or Loss is very similar:

$$\textbf{Restated Amount} = \text{Transaction price prior to restatement} \times \frac{\text{GPI at reporting date}}{\text{GPI at acquisition date}}$$

Income and expenses are restated by applying the change in the GPI from the date when the items were initially recorded and to the end of the reporting period. In case of taxes, the difference in assets and liabilities due to restatement is tax deductible or payable in the next period.

The gain or loss on the net monetary position is derived as the difference resulting from the restatement of nonmonetary assets, owners' equity and items in the statement of comprehensive income and the adjustment of index linked assets and liabilities. An increase in the value of PPE, for Example, will simply be debited to the asset and credited to the profit and loss (before tax) as a monetary gain.

1.1.4 Disclosures

The corresponding figures for the previous period required by IFRS 18, and any information in respect of earlier periods should also be stated in terms of the measuring unit current at the end of the reporting period.

When companies present comparative amounts in a different presentation currency, IAS 21 should be applied.

The gain or loss on the net monetary position shall be included in profit or loss and separately disclosed.

The following disclosures are also required by IAS 29:

- The fact that the financial statements and the corresponding figures for previous periods have been restated for the changes in the general purchasing power of the functional currency and, as a result, are stated in terms of the measuring unit current at the end of the reporting period;
- Whether the financial statements are based on a historical cost approach or a current cost approach; and

- The identity and level of the price index at the end of the reporting period and the movement in the index during the current and the previous reporting period.

Example

Company E has a year end of 31 December. In April 20X4 it recognises that it is now operating in a hyperinflationary environment and decides to apply IAS 29 for the entire year. The value of PPE at 31 December 20X3 and 20X4 held at historic cost (before restatement) is as follows:

Non-Current Assets	31 Dec 20X4	31 Dec 20X3
PPE	300	400

The PPE was acquired in December 20X2 and has been depreciated over its five-year useful life.

The GPI at each year end since acquisition is shown in the table below:

Date	GPI
31 Dec 20X2	95
31 Dec 20X3	135
31 Dec 20X4	223

To calculate the conversion factor we divide the GPI at the reporting date by the GPI at the acquisition date, and multiply the result by the carrying value of the PPE.

20X2 Conversion Factor = 223/ 95 = **2.35**

20X3 Conversion Factor = 223/ 135 = **1.65**

20X4 Conversion Factor = 223/ 223 = **1**

To restate the balance of PPE we will need to apply the conversion factors, for Example, cost of PPE 500 x 2.35 = 1 175:

	Historic	Restated
Cost of PPE	**500**	**1 175**
Depreciation 20X3	(100)	(235)
Carrying Amount 31 Dec 20X3	**400**	**939**
Depreciation 20X4	(100)	(235)
Carrying Amount 31 Dec 20X4	**300**	**705**

Company E will recognise the significant inflationary increase in the value of PPE with the following entries:

Dr: PPE	675
Cr: Acc Dpcn	135
Cr: Profit and loss – Monetary gain	540

As you can see this is a laborious process, and it needs to be done for every transaction and balance in the financial statements. The fact that this is a very complex process depending on the correct application of a suitable and accurate index makes reporting in a hyperinflationary environment inherently less reliable than normal.

1.2 Interim Financial Reporting

Companies produce a variety of reports for internal use throughout the year, but financial accounting is primarily concerned with the annual financial statements that companies produce for external use. As you are aware, equity investors without operational responsibility are dependent on the information that companies choose to publish. Consequently, most agencies responsible for overseeing publicly listed companies, such as the Securities and Exchange Commission in the USA, require companies to report publicly more frequently than once a year. This type of financial report is referred to as an interim report and listing rules around the world often require these reports to be produced quarterly, to aid decision making for those who are trading company shares.

Interim reports are thus not mandated by accounting standards, but IAS 34 has been issued to enable companies to comply with accounting principles in the production of interim reports, and hence improve their usability and consistency with annual reporting.

IAS 34 is applied to interim reports that are described as complying with IFRS. There are two primary issues in terms of accounting standards in relation to interim reports. The first is the comparators that should be used, and the second is the format of the financial statements included in the interim report. The latter is important because interim reports do not typically include the full suite of notes required by the standards.

Given that IAS 34 is not mandatory, it does not include any requirements in terms of when interim reports should be produced. However, IAS 34 encourages publicly traded entities:

a. To provide interim financial reports at least as of the end of the first half of their financial year; and

b. To make their interim financial reports available no later than 60 days after the end of the interim period.

The primary goal of IAS 34 is to improve the consistency of interim reporting, and the standard thus specifies that the following principles outlined in IFRS 18 should be applied:

c. Fair presentation and compliance with IFRS Accounting Standards;

d. Going concern;

e. Accrual basis of accounting;

f. Materiality and aggregation; and

g. Offsetting.

Essentially, IAS 34 expects companies to apply the same accounting policies for recognition and measurement in its interim reports as it uses in its annual accounts.

The components of an interim report are described by IAS 34 as follows:

Entities reporting in accordance with IAS 34 are required to include in their interim financial reports, at a minimum, the following components:

h. a condensed statement of financial position;

i. a condensed statement of comprehensive income, presented as either:

   i. a condensed single statement; or

   ii. a condensed separate Statement of Profit or Lossand a condensed statement of comprehensive income;

j. a condensed statement of changes in equity;

k. a condensed statement of cash flows; and

l. selected explanatory notes.

If the entity's most recent annual financial statements were consolidated statements, then the interim financial report should also be prepared on a consolidated basis. Entities that present the components of profit or loss in a separate Statement of Profit or Loss should also present interim condensed information in a separate statement. We will explain what condensed means in the context of the standard once we have considered comparators.

One important factor to consider when interpreting interim reports is that they are not normally subject to audit and the information is produced with relative rapidity. The information thus presents some risks for users, in terms of accuracy and comprehensiveness, for Example.

1.2.1 Comparators

When preparing interim reports, it is important that the results obtained in the period covered are compared to an appropriate basis. This differs depending on the individual financial statements, which are either compared to the prior financial year end, or to the equivalent period from the prior financial year. The table below sets out the correct comparators for each statement:

Statement	Current	Comparative
Statement of financial position	End of current interim period	End of immediately preceding financial year
Statement of comprehensive income	Current interim period and cumulatively for the year to date	Comparable interim period and year to date of immediately preceding financial year
Statement of changes in equity	Cumulatively for the current financial year to date	Comparable year to date of immediately preceding financial year
Statement of cash flows	Cumulatively for the current financial year to date	Comparable year to date of immediately preceding financial year

The Statement of Financial Position is thus compared to the prior year end, to enable the interim report to indicate how the value of the business has changed in the period (balances are always cumulative, so this isn't specified). The Statement of Profit or Loss has two comparators, one showing the totals to date and one showing the equivalent period for the prior year. The other two statements are simpler and show the cumulative totals for the year to date. This guidance is particularly useful for companies that produce quarterly, rather than half yearly, reports.

To illustrate the comparators the following table is provided, showing the comparators for a company that reports half yearly with a year end of 31 December:

Statement	Current	Comparative
Statement of financial position	30 June 20X5	31 December 20X4
Statement of comprehensive income	30 June 20X5	30 June 20X4
Statement of changes in equity	30 June 20X5	30 June 20X4
Statement of cash flows	30 June 20X5	30 June 20X4

Some types of business, for Example tourism and agriculture, tend to be highly seasonal, so quarterly reports may present a misleading picture of the entity's performance if users do not understand how the business operates. A hotel company's quarterly reports could in principle show 3 quarters of loss- making activity, compensated with a profit in 1 quarter. Entities whose business is highly seasonal are thus encouraged by IAS 34 to disclose financial information relating to the twelve months up to the end of the interim period, and comparative information for the equivalent twelve-month period in the prior year.

1.2.2 Condensed Financial Statements

The financial statement presented in the interim report should be as close as possible in format and disclosures to the annual financial statements. However, companies are not expected to produce all the notes required in the annual accounts. In terms of the format of the financial statements IAS 34 requires for each component or statement, that each of the headings and subtotals that were included in the entity's most recent annual financial statements should be disclosed. Additional line items are required if their omission would make the condensed interim financial statements misleading.

Given that the notes supplementing the interim financial statements are limited, the presentation package taken together is condensed from what would be reported in a complete set of financial statements under IFRS 18 and other Standards. In such circumstances, the information presented in the different statements is condensed, even if the appearance of the statements has not changed. These interim statements should therefore be described as 'condensed', because otherwise a user might infer that they constitute a complete set of financial statements under IFRS 18, which they do not. A complete set of financial statements must include a full note presentation consistent with the annual presentation.

1.2.3 Notes to the Interim Reports

The disclosure requirements of IAS 34 assume that anyone reading the interim financial report will have access to the most recent annual financial statements. Therefore, not all the supplementary notes in the annual financial statements are required for interim reporting purposes, because this would result in repetition, or the reporting of relatively insignificant changes.

The explanatory notes included with the interim financial information are intended to provide an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period.

The list below sets out the minimum explanatory notes required by IAS 34. The information is generally presented on a financial year-to-date basis. However, the entity is also required to disclose any events or transactions that are material to an understanding of the current interim period.

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

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

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

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

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

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

(g) the following segment information:

  (i) revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;

  (ii) intersegment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;

  (iii) a measure of segment profit or loss;

  (iv) total assets for which there has been a material change from the amount disclosed in the last annual financial statements;

  (v) a description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss; and

  (vi) a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and

discontinued operations.

(h) material events subsequent to the end of the interim period that have not been reflected in the interim financial statements;

(i) the effect of changes in the composition of the entity during the interim period, including business combination, obtaining or losing control of subsidiaries and long-term investments, restructurings and discontinued operations; and

(j) changes in contingent liabilities or contingent assets since the end of the last reporting period.

It should be noted that materiality in interim reporting is defined by the period's results, not the results reported in the annual accounts. Hence items which may not be material in the context of the year may need to be reported in the interim report.

1.3 Related Parties

Related Parties potentially present significant financial risk to the owners of companies, particularly where the owners do not exercise operational control, like most shareholders for Example. Related parties can be understood as individuals or companies that have relationships with the reporting entity which allow them to influence decisions to their own benefit. Related parties can include managers within the entity who have authority in specific areas, such as a procurement manager, or more widespread authority, such as the CEO, or members of the Board. They can include suppliers who have been issued shares in the entity, and they always include senior management and members of the same group of companies.

Due to the degree of risk that these relationships potentially present, IAS 24 ***Related Party Transactions*** has been issued to require disclosures about transactions and outstanding balances with an entity's related parties. The standard defines various classes of entities and people as related parties and sets out the disclosures required in respect of those parties, including the compensation of key management personnel.

A related party is a person or entity that is related to the entity that is preparing its financial statements.

In accordance with IAS 24:

(a) A person or a close member of that person's family is related to a reporting entity if that person:

  (i) has control or joint control over the reporting entity;

  (ii) has significant influence over the reporting entity; or

  (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:

  (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

  (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

  (iii) Both entities are joint ventures of the same third party.

(iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

(v) The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

(vi) The entity is controlled or jointly controlled by a person identified in (a).

(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

(viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

The following types of relationship are deemed not to be related:

- Two entities simply because they have a director or key manager in common
- Two venturers who share joint control over a joint venture
- Providers of finance, trade unions, public utilities, and departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity, simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process)
- A single customer, supplier, franchiser, distributor, or general agent with whom an entity transacts a significant volume of business merely by virtue of the resulting economic dependence.

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

1.3.1 Disclosure

Relationships between parents and subsidiaries. Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so must also be disclosed.

Management compensation. Disclose key management personnel compensation in total and for each of the following categories:

- short-term employee benefits
- post-employment benefits
- other long-term benefits
- termination benefits
- share-based payment benefits

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

If an entity obtains key management personnel services from a management entity, the entity is not required to disclose the compensation paid or payable by the management entity to the management entity's employees or directors. Instead, the entity discloses the amounts incurred by the entity for the provision of key management personnel services that are provided by the separate management entity.

1.4 Operating Segments

Companies are typically comprised of many different functions, product lines and other components and it is common for certain core operations to have an oversized impact on the company's financial results. Because these components may not be very visible to users of traditional financial statements, IASB has issued a standard that requires specific disclosures about these components, called Segments. IFRS 8 ***Operating Segments*** applies to the separate or individual financial statements of an entity (and to the consolidated financial statements of a group with a parent):

- Whose debt or equity instruments are traded in a public market or
- That files, or is in the process of filing, its (consolidated) financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market

When both separate and consolidated financial statements for the parent are presented in a single financial report, segment information need be presented only on the basis of the consolidated financial statements.

Segment reporting, as is common with many issues throughout this Unit, is thus a requirement for publicly listed companies, or those that raise debt in public markets. Operating segments

IFRS 8 defines an operating segment as a component of an entity:

- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity)
- Whose operating results are reviewed regularly by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance and
- For which discrete financial information is available

An operating segment may engage in activities that do not yet generate revenue, such as start-up operations, which can still be considered operating segments before they begin earning revenues. The identification of operating segments involves the role of the 'Chief Operating Decision Maker' (CODM), which is a function rather than a specific managerial position. This function encompasses allocating resources and assessing the performance of the entity's operating segments. Typically, the CODM could be the CEO, COO, a group of executive directors, or others.

If an entity presents its business activities in various formats and the CODM uses multiple sets of segment information, other factors, such as the nature of business activities, the presence of responsible managers, and information provided to the board, may determine the primary set of operating segments.

An operating segment generally has a 'segment manager,' who directly reports to and communicates with the CODM regarding the segment's operations, financial results,

forecasts, and plans. This role, similar to that of the CODM, is defined by its function, not necessarily by a specific title. Sometimes, the CODM might also act as the segment manager for certain segments, and a single manager might oversee multiple segments.

Reportable segments

Just because a company has identified an operating segment, it does not necessarily follow that it must report that segment in the financial statements. IFRS 8 therefore includes quantitative requirements to help companies identify those segments that are significant enough to the company to warrant specific disclosure. Reportable segments are operating segments or aggregations of operating segments that meet the following criteria:

- Its reported revenue, from both external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments, or
- The absolute measure of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of
    I. the combined reported profit of all operating segments that did not report a loss and
    II. the combined reported loss of all operating segments that reported a loss, or
- Its assets are 10 per cent or more of the combined assets of all operating segments.

Note the use of "or" in this requirement: an operating segment should be reported if it meets at least one of the criteria. Two or more operating segments may be aggregated into a single reporting segment if aggregation is consistent with the core principles of the standard, the segments have similar economic characteristics and are similar in various prescribed respects.

If the total external revenue reported by operating segments constitutes less than 75 per cent of the entity's revenue, additional segments must be identified as reportable segments (even if they do not meet the quantitative thresholds set out above) until at least 75 per cent of the entity's revenue is included in reportable segments.

Example

Company G has structured its business into four operating segments. Identify which of these should be reported under IFRS 8:

Component	Revenue		Profit	Assets
	External	*Internal*		
A	80 000	0	10 000	50 000
B	0	45 000	5 000	30 000
C	10 000	0	1 000	4 000
D	8 000	0	500	3 000
Total	**98 000**	**45 000**	**16 500**	**87 000**

Components A and B would be separately reportable since they meet all three size criteria. Components C and D do not meet any of the size criteria and on the face of it are not separately reportable. However, if they had similar economic characteristics they could be aggregated into a combined segment that would then be over the 10% threshold for revenue and so could be reported.

1.4.1 Disclosures

IFRS 8 requires considerable additional disclosures, including the following:

- General information about how the entity identified its operating segments and the types of products and services from which each operating segment derives its revenues
- Judgements made by management in applying the aggregation criteria to allow two or more operating segments to be aggregated
- Information about the profit or loss for each reportable segment, including certain specified revenues and expenses such as revenue from external customers and from transactions with other segments, interest revenue and expense, depreciation and amortisation, income tax expense or income and material non-cash items
- A measure of total assets and total liabilities for each reportable segment, and the monetary value of investments in associates and joint ventures and the amounts of additions to certain non-current assets ('capital expenditure')
- An explanation of the measurements of segment profit or loss, segment assets and segment liabilities, including certain minimum disclosures, e.g. How transactions between segments are measured, the nature of measurement differences between segment information and other information included in the financial statements, and asymmetrical allocations to reportable segments
- Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material items to corresponding items in the entity's financial statements
- Some entity-wide disclosures that are required even when an entity has only one reportable segment, including information about each product and service or groups of products and services
- Analyses of revenues and certain non-current assets by geographical area – with an expanded requirement to disclose revenues/assets by individual foreign country (if material), irrespective of the identification of operating segments
- Information about transactions with major customers

Essentially, IFRS 8 requires companies to produce restatements of their profit and loss and statement of financial performance allocating the results and balances to the different reporting segments to show how they have performed. This is intended to help users of the financial statements to understand whether, for Example, the company's strategy is utilising its most productive segments appropriately.

C.2 Disclosure of Financial Information in the Public Sector

2. Presentation of Budget Information

Public sector entities are subject to significant financial oversight because of their responsibility for implementing government policy and managing public funds. Central governments generally publish their budgets in some form as a way of presenting to the public how they intend to allocate financial resources to deliver the government's plans. In most countries annual budgets are legal Acts, passed by the legislature and subject to debate, and are thus exposed to considerable scrutiny. Following the end of the financial year, governments will typically return to the legislature to present the "budget outturn" which is a financial statement showing the actual amounts spent against the amounts authorised in the Act. Unlike in the private sector, where underspending generally suggests efficiency, in the public sector less expenditure generally correlates with less service delivery, so the outturn is an important indicator of whether the government has delivered on its commitments. Due to the importance of the budget outturn to fulfilling the government's fiduciary responsibilities, IPSAS have developed a standard to assist entities with integrating the outturn into the IPSAS financial statements.

All public sector entities, except for Government Business Enterprises (GBEs), are required to follow IPSAS 24. Because GBEs, by definition, operate on a commercial basis it is not appropriate for them to publish their operating budgets, and so they are excluded from the standard. IPSAS 24 states that an entity shall present a comparison of the budget amounts for which it is held publicly accountable and actual amounts, either as a separate additional financial statement or as additional budget columns in the financial statements currently presented in accordance with IPSASs.

The comparison of budget and actual amounts shall present separately:

a) The original and final budget amounts;

b) The actual amounts on a comparable basis; and

c) By way of note disclosure, an explanation of material differences between the budget for which the entity is held publicly accountable and actual amounts.

An entity shall present a comparison of budget and actual amounts as additional budget columns in the primary financial statements only where the financial statements and the budget are prepared on a comparable basis.

Where the budget and financials are prepared on a comparable basis, the entity can choose to present the comparison as a separate statement, or add additional columns to the appropriate statements. If the basis of accounting differs, the entity must use a separate statement which shows the results on the same basis, so if the budget is cash, the budget statement prepared under IPSAS 24 should also be on a cash basis.

Where the budget is changed during the year the entity should report both the original and final budget figures. The entity should also present an explanation of whether changes between the original and final budget are a consequence of reallocations within the budget, or of other factors:

- By way of a note disclosure in the financial statements; or
- In a report issued before, at the same time as, or in conjunction with, the financial statements, and shall include a cross reference to the report in the notes to the financial statements.

An entity shall explain in notes to the financial statements the budgetary basis and classification basis adopted in the approved budget. The classification basis can vary depending on the entity, it may use program-based budgets, or the more traditional functional classification (health, education, and so on).

Entities are also required to report the period of the budget and the entities which are included in it, in effect a consolidated presentation indicating the entities that are funded by the budget, like ministries or departments for Example.

2.2 Operating Segments

IPSAS 18 Segment Reporting was issued in 2002 and is thus drawn primarily from IAS 14. Since it has not been updated to reflect the changes adopted for segment reporting in IFRS 8. we will therefore consider here the main differences between IPSAS 18 and IFRS 8. The differences mainly arise because segments in the public sector are not based on financial performance but on operational significance (budget/expenditure rather than revenue). Segment reporting can be seen simply to report on the financial sustainability of major components of a company, and that is not usually relevant in the public sector, where few components generate revenue. Other differences relate to the different terminology in use by IPSAS:

- IPSAS 18 defines segments differently from IFRS 8. IPSAS 18 requires entities to report segments on a basis appropriate for assessing past performance and making decision about the allocation of resources. IFRS 8 requires business and geographical segments to be reported.
- Commentary additional to that in IFRS 8 has been included in IPSAS 18 to clarify the applicability of the standards to accounting by public sector entities.
- IFRS 8 requires disclosure of segment result, depreciation and amortisation of segment assets and other significant non-cash expenses. IPSAS 18 does not require the disclosure of segment result. IPSAS 18 encourages, but does not require, the disclosure of significant non-cash revenues that are included in segment revenue, segment depreciation and other non-cash expenses or segment cash flows as required by IPSAS 2 Statement of Cash Flows.
- IPSAS 18 does not specify quantitative thresholds that must be applied in identifying reportable segments.
- IPSAS 18 uses different terminology, in certain instances, from IFRS 8. The most significant Examples are the use of the terms like “entity”, “revenue”, “statement of financial performance”, “statement of financial position” and “net assets/equity”. The equivalent terms in IAS 14 are “enterprise”, “income”, “income statement”, “balance sheet” and “equity”.

The types of segments reported to the governing body and senior manager of a public sector entity are frequently referred to as “service segments” or “geographical segments”. These terms are used in IPSAS 18with the following meanings:

- A “service segment” refers to a distinguishable component of an entity that is engaged in providing related outputs or achieving operating objectives consistent with the overall mission of each entity; and
- A “geographical segment” is a distinguishable component of an entity that is engaged in providing outputs or achieving operating objectives within a particular geographical area.

Government departments and agencies are usually managed along service lines because this reflects the way in which major outputs are identified, their achievements monitored, and their resource needs identified and budgeted. An Example of service lines or service segments is an education department whose organisational structure and internal reporting system reflects primary, secondary and tertiary educational activities and outputs as separate segments. Hence the standard recommends the use of these classifications, to reflect management practice and user needs. IPSAS 18 does not require complex disclosures because it recognises that they serve a different purpose in the public sector, and the costs of providing this information should be weighed against the benefit to users.

2.3 General Government Sector

The General Government Sector (GGS) is a category used in statistical reporting to identify public sector organisations that fulfil the core functions of government as their primary activity. Statistical bases of financial reporting such as the System of National Accounts, Government Finance Statistics Manual, and the European System of Accounts require governments to compile financial information about the General Government Sector (GGS). For statistical purposes, the GGS comprises those non-profit entities which undertake non market activities and rely primarily on appropriations or allocations from the government budget to fund their service delivery activities (hereafter referred to as non-market entities or activities). The statistical bases of financial reporting may also provide information about the corporation sector of government which primarily engages in market activities (usually characterised as the public financial corporation sector and the public non-financial corporations sector) and the public sector as a whole. The standard summarises as follows: "Under statistical bases of financial reporting the public sector comprises of:

- The General Government Sector (GGS),
- the Public Financial Corporations (PFC) sector and
- the Public Non-Financial Corporations (PNFC) sector.

Additional subgroups within these sectors may be identified for statistical analytical purposes. The approach taken thus separates entities based on their primary source of funds: if they depend on taxes and transfers, they are part of the GGS, if they do not, they are public corporations. This is as you can see a very different way of grouping entities together than that used under IFRS, based on control.

In some jurisdictions, for Example, a national government controls state/provincial and local government entities, and therefore its financial statements consolidate those levels of government, but in other jurisdictions they do not. In all jurisdictions, under statistical bases of financial reporting, the GGS of all levels of government are combined, so in some jurisdictions the GGS will include units that financial statements do not consolidate.

In other words, there is a discrepancy between accounting and statistical bases of classifying government organisations, since the former uses the accounting definition of control, and the latter does not. IPSAS 22 *Disclosure of Information about the General Government Sector* was issued to help address this discrepancy by assisting reporting entities to disclose appropriate information about the GGS in their financial statements.

As is common with the standards covered by this Unit, the standard is mandatory for those that choose to disclose information in their financial statements about the GGS.

2.3.1 Disclosures

According to IPSAS 22, financial information about the general government sector should be disclosed in conformity with the accounting policies adopted for preparing and presenting the consolidated financial statements of the government, except with respect to entities in the public corporation sector. So GSS entities should be consolidated, because their primary source of funds indicates accounting control for the purpose of IPSAS 6 *Consolidated Financial Statements and accounting for Controlled Entities*.

Public corporations are not consolidated, instead they are treated as investments, and carried as assets "at the carrying amount of the net assets of its investees." This means that the investment is valued at the carrying amount of the public corporation's net assets multiplied by the % share of the total ownership of the public corporation.

The specific disclosures to be made about the GSS are set out in the standard are:

(a) Assets by major class, showing separately the investment in other sectors;

(b) Liabilities by major class;

(c) Net assets/equity;

(d) Total revaluation increments and decrements and other items of revenue and expense recognised directly in net assets/equity;

(e) Revenue by major class;

(f) Expenses by major class;

(g) Surplus or deficit;

(h) Cash flows from operating activities by major class;

I. Cash flows from investing activities; and

II. Cash flows from financing activities.

The manner of presentation of the general government sector disclosures should be no more prominent than the government's financial statements prepared in accordance with IPSAS 22.

Entities preparing general government sector disclosures should also disclose the significant controlled entities that are included in the general government sector and any changes in those entities from the prior period, together with an explanation of the reasons for such changes.

A reconciliation between the GGS results and the IPSAS results is also required.

IPSAS 22 states that the GGS disclosures should be reconciled to the consolidated financial statements of the government, showing separately the amount of the adjustment to each equivalent item in those financial statements.

C.3 Non-Financial Information

3.1 Issues in Financial Reporting

For most of its history, accounting and reporting practices remained largely consistent, involving men (usually men) scratching entries in large ledger books and manually compiling reports from paper records. With the development of the computer as a

practical business tool in the years following World War 2, things started to change quite rapidly. The speed of change seems to have accelerated since the 1990s when personal computers became widespread, and faster processing speeds and cheaper memory have since enabled companies to produce, analyse and use vast amounts of information about company activities. Computing power has thus enabled companies to also present more information to their stakeholders, and this increased supply of information has led to demands for it to be regularised and published. The Global Financial Crisis of 2008 also played a significant role in increased demands for more comprehensive financial and performance reporting.

In this section we are going to be looking at a number of different areas in financial and performance reporting that relate to limitations in current practice. Several relatively recent initiatives to improve performance reporting, for Example, explicitly acknowledge gaps that exist between user needs and financial statements.

Financial reporting is inevitably and unavoidably limited in the sense that it involves the application of judgement, which may be subjective, and because management have the opportunity to manipulate results. In other words, financial reporting is always at risk of accidental or deliberate misstatement. Some common issues with financial reporting are as follows:

- Subjective judgements may lead to inaccurate reports.
- Misleading comparisons that do not provide a true picture of the company's financial health.
- Manipulation due to misaligned incentives.
- Regulatory challenges from ever-evolving regulations.
- Technological challenges.
- Data accuracy and integrity issues.
- Ethical concerns related to financial reporting.

Financial reporting is also of course, always retrospective and looks backwards, which means that in itself it provides no guidance as to future results. One of the main focuses of recent developments in financial reporting is therefore on developing guidance to help companies integrate their financial results with their forward-looking assessments of their strategic plans and direction.

3.2 Management Commentary

Management commentary refers to the narrative that company management provides to add context and explanation to the results reported in the financial statements. The IASB issued an IFRS Practice Statement 1 *Management Commentary* to provide guidance to companies seeking to improve the interaction between the financial statements and the accompanying narrative. IFRS Practice Statement 1 is a non-mandatory publication which offers guidance on how to use judgement to make decisions about the information to present in the financial statements.

The IFRS Practice Statement 1 includes a basis for conclusions that explains the logic behind the statement's guidance. It states that the purpose of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. However, financial statements do not provide all the information that users need to make economic decisions because the financial statements primarily present the financial effects of past

events and do not provide non-financial measures of performance or a discussion of prospects and plans. Management commentary thus supplements and complements the financial statements by addressing this limitation.

The purpose of the IFRS Practice Statement 1 is to improve the usefulness of the information provided in an entity's management commentary so that, when it is provided in conjunction with the financial statements, users are better able to make decisions about providing resources to the entity.

Governments, securities regulators, stock exchanges and professional accountancy bodies often require entities whose debt or equity securities are publicly traded, in other words, publicly listed companies, to publish management commentary. Management commentary encompasses reporting that jurisdictions may describe as management's discussion and analysis, operating and financial review, business review or management's report. Hence, just as with the interim reporting standard, the practice note meets a regulatory requirement and is intended to improve the usefulness of the financial statements, in this case by providing guidance which can be used to align them with the commentary.

The IASB decided to provide guidance on the content of management commentary in the form of a non-binding practice statement, rather than an IFRS, because it believes it is up to individual jurisdictions to make their own judgements on:

(a) Whether entities should be required to include management commentary in addition to their IFRS financial statements and whether inclusion is necessary to assert compliance with IFRSs;

(b) The level of assurance to which management commentary should be subjected;

(c) The necessity of 'safe harbour' provisions in relation to the inclusion of forward-looking information; and

(d) The type of entity that should present management commentary.

Companies issuing reports with management commentary are thus expected to meet national reporting requirements, which should define the issues noted above, as well as other matters. The positioning of management commentary relative to the financial statements, for Example, varies among jurisdictions that require management commentary. In some jurisdictions, management commentary accompanies the annual financial statements in a printed report to shareholders. In others, management commentary is contained within separate annual regulatory filings.

3.2.1 Aspects of Management Commentary

According to the practice note, management should present commentary that is consistent with the following principles:

(a) To provide management's view of the entity's performance, position and progress; and

(b) To supplement and complement information presented in the financial statements.

In aligning with those principles, management commentary should include:

a) Forward-looking information; and

b) Information that possesses the qualitative characteristics described in the

conceptual framework for financial reporting.

Management commentary should provide information to help users of the financial reports to assess the performance of the entity and the actions of its management relative to stated strategies and plans for progress. That type of commentary will help users of the financial reports to understand, for Example:

a) The entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies;

b) How resources that are not presented in the financial statements could affect the entity's operations; and

c) How non-financial factors have influenced the information presented in the financial statements.

Management's view

Management commentary should provide management's perspective of the entity's performance, position and progress. Management commentary should derive from the information that is important to management in managing the business.

Management commentary should supplement and complement the financial statements with explanations of the amounts presented in the financial statements and the conditions and events that shaped that information. Management commentary should also include information about the entity and its performance that is not presented in the financial statements but is important to the management of the entity.

Forward-looking information

Management commentary should communicate management's perspective of the entity's direction. Such information does not predict the future, but instead sets out management's objectives for the entity and its strategies for achieving those objectives. The extent to which management commentary looks forward will be influenced by the regulatory and legal environment within which the entity operates.

Management should include forward-looking information when it is aware of trends, uncertainties or other factors that could affect the entity's liquidity, capital resources, revenues and the results of its operations. Such information should focus on the extent to which the entity's financial position, liquidity and performance may change in the future and why, and include management's assessment of the entity's prospects in the light of current period results. Management should provide forward-looking information through narrative explanations or through quantified data, which may—but are not required to—include projections or forecasts. Management should disclose the assumptions used in providing forward-looking information.

Management should explain how and why the performance of the entity is short of, meets or exceeds forward-looking disclosures made in the prior period management commentary. For Example, if management stated targets for future performance in previous reporting periods, it should report the entity's actual performance in the current reporting period and analyse and explain significant variances from its previously stated targets as well as the implications of those variances for management's expectations for the entity's future performance.

Other characteristics

Information in management commentary should possess the fundamental qualitative characteristics of relevance and faithful representation. Information in management commentary should also maximise the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability.

Management should include information that is material to the entity in management commentary. Materiality will be different for each entity. Materiality is an 'entity-specific aspect of relevance'; thus, information that is relevant for an entity will also be material.

3.2.2 Presentation

Management should identify clearly what it is presenting as management commentary and distinguish it from other information. When management commentary is presented, management should explain the extent to which the IFRS Practice Statement 1 has been followed. An assertion that management commentary complies with the IFRS Practice Statement 1 can be made only if it complies with the practice statement in its entirety.

Although the particular focus of management commentary will depend on the facts and circumstances of the entity, management commentary should include information that is essential to an understanding of:

a) The nature of the business;

b) Management's objectives and its strategies for meeting those objectives;

c) The entity's most significant resources, risks and relationships;

d) The results of operations and prospects; and

e) The critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

Management commentary should be presented with a focus on the most important information in a manner intended to address the principles described in the IFRS Practice Statement 1 statements. If the financial statements include segment information, the information presented in the management commentary should reflect that segmentation.

a) When practicable, management should avoid duplicating in its management commentary the disclosures made in the notes to its financial statements. Reciting financial statement information without analysis, or presenting boilerplate discussions that do not provide insight into the entity's past performance or prospects, is unlikely to provide information that is useful to users of the financial reports and may create an obstacle for users to identify and understand the most significant matters facing the entity.

b) Management should also avoid generic disclosures that do not relate to the practices and circumstances of the entity and immaterial disclosures that make the more important information difficult to find.

In addition to the IFRS Practice Statement 1, there is other guidance available to support companies in improving the quality of their reporting, and that relating to sustainability is currently a major focus for the profession. You were introduced to the Global Reporting Initiative in the Financial Reporting paper, as well as to the IFRS Sustainability Standards in Unit B of this module, and you should be aware of these developments and be able to discuss them in the exam, alongside consideration of the related contents of this Unit.

3.3 Integrated Reporting

You have now encountered various frameworks for supporting the development of improved information in the financial statements, by making them communicate more effectively with other related information, such as management commentary and interim reporting. Integrated reporting is an international framework which applies more broadly to all information companies produce for public consumption, rather than primarily being directed to the financial statements. The framework, commonly referred to as"<IR>", is issued by a body that is directed jointly by the IASB and the International Sustainability Standards Board (ISSB). The framework is available as a PDF to download from the IFRS website, (after registration) using the link: ***https://www.ifrs.org/issued-standards/ir-framework/***

The purpose of the Framework is to establish Guiding Principles and Content Elements that govern the overall content of an integrated report, and to explain the fundamental concepts that underpin them.

According to the framework, "an integrated report is intended to explain to providers of financial capital how an organisation creates, preserves or erodes value over time. An integrated report benefits all stakeholders interested in an organisation's ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policy-makers."

The integrated reporting framework is thus intended for companies that are publicly listed. The emphasis in integrated reporting is on how management is protecting the investment of shareholders and creditors and complying with relevant regulations. It refers to this as value creation, and the framework essentially provides a set of principles and concepts that a company can apply when attempting to define and measure how it creates value, or whether value is being preserved, or eroded. Time is thus also an inherently important factor in integrated reporting, and the framework requires companies to consider the direction in which the company is moving over different time frames.

An integrated report aims to provide insight about the resources and relationships used by an organisation, collectively referred to as "the capitals" in the Framework. It also seeks to explain how the organisation interacts with the external environment and the capitals to create, preserve or erode value over the short, medium and long term.

It should be noted that application of the integrated reporting framework is not a mandatory requirement in terms of accounting compliance, even for listed companies. Just as you saw with both IFRS Practice Statement 1 *Management Commentary* and IAS 34 *Interim Financial Reporting*, the requirements are only mandatory if the company chooses to say that it is applying them. You cannot, in other words, claim to be presenting information in accordance with the integrated reporting framework, unless you specifically follow all of the relevant requirements. Despite the requirements for integrated reporting being quite considerable, they have been adopted widely, particularly in developed economies. We will look in more detail at the various aspects of integrated reporting after considering why companies are choosing to adopt this type of reporting.

One reason companies apply the framework in presenting integrated reports is because of regulatory compliance. As you learned with interim reporting, reporting rules are often set by relevant financial authorities such as the SEC in the USA, and according to the IFRS the integrated reporting framework is being applied in 75 countries around the world, most of whom can be assumed to have made it mandatory. For multi-national companies, being listed on large, liquid exchanges like London and New York makes it significantly easier to raise capital, and this makes compliance with their advanced

reporting requirements necessary. More broadly, the framework provides a useful way of explaining to the wider world how a company's strategy is delivering value and also encourages the development of more useful internal information for decision making. Its adoption may thus benefit a company irrespective of national reporting requirements.

At the heart of integrated reporting is the growing realisation that a wide range of factors determine the value of an organisation, some of these are financial or tangible in nature and are easy to account for in financial statements, while many such as intellectual capital, competition and energy security are not.

Integrated reporting reflects the broad and longer-term consequences of the decisions organisations make, based on a wide range of factors, in order to create and sustain value. Integrated reporting enables an organisation to communicate in a clear, articulate way how it is drawing on all the resources and relationships it utilises to create and preserve value in the short, medium and long term, helping investors to manage risks and allocate resources most efficiently.

Creation of value

The creation of value is defined in the framework as "the process that results in increases, decreases or transformations of the capitals caused by the organisation's business activities and outputs."

3.3.1 Guiding Principles and Fundamental Concepts

Integrated reporting is founded on **seven guiding principles** that should underpin the preparation and presentation of an integrated report, informing the content of the report and how information is presented:

1. **Strategic focus and future orientation.** An integrated report should provide insight into the organisation's strategy, and how it relates to the organisation's ability to create value in the short, medium and long term, and to its use of and effects on the capitals.
2. **Connectivity of information.** An integrated report should show a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organisation's ability to create value over time.
3. **Stakeholder relationships.** An integrated report should provide insight into the nature and quality of the organisation's relationships with its key stakeholders, including how and to what extent the organisation understands, takes into account and responds to their legitimate needs and interests.
4. **Materiality.** An integrated report should disclose information about matters that substantively affect the organisation's ability to create value over the short, medium and long term.
5. **Conciseness.** An integrated report should be concise.
6. **Reliability and completeness.** An integrated report should include all material matters, both positive and negative, in a balanced way and without material error.
7. **Consistency and comparability.** The information in an integrated report should be presented:
    (a) on a basis that is consistent over time; and

(b) in a way that enables comparison with other organisations to the extent it is material to the organisation's own ability to create value over time.

The principles therefore are directed at how the information should be presented, and they share a number of characteristics with the conceptual framework. To help define the subject matter of the integrated report, the framework is founded on two fundamental concepts, the first is that an integrated report should explain how an organisation creates, preserves or erodes value over time. The second is that value is not created, preserved or eroded by or within an organisation alone. It is:

- Influenced by the external environment
- Created through relationships with stakeholders
- Dependent on various resources

The types of resources that the company depends on include both tangible and intangible, financial, intellectual and social. They are referred to in the framework as "capitals" and are grouped into six categories, which we will look at shortly. Companies are advised to embrace what the framework calls "integrated thinking" in order to engage productively with the framework.

Integrated thinking is the active consideration by an organisation of the relationships between its various operating and functional units and the capitals that the organisation uses. Integrated thinking leads to integrated decision making and actions that consider the creation, preservation or erosion of value over the short, medium and long term.

3.3.2 The Six Capitals

The six capitals are summarised in the table below:

Capital	Explanation
1. Financial capital	The pool of funds that is: Available to an organisation for use in the production of goods or the provision of services Obtained through financing, such as debt, equity or grants, or generated through operations or investments.
2. Manufactured capital	Manufactured physical objects (as distinct from natural physical objects) that are available to an organisation for use in the production of goods or the provision of services, including: Buildings Equipment Infrastructure (such as roads, ports, bridges, and waste and water treatment plants). Manufactured capital is often created by other organisations, but includes assets manufactured by the reporting organisation for sale or when they are retained for its own use.

Capital	Explanation
3. Intellectual capital	Organisational, knowledge-based intangibles, including: Intellectual property, such as patents, copyrights, software, rights and licences "Organisational capital" such as tacit knowledge, systems, procedures and protocols
4. Human capital	People's competencies, capabilities and experience, and their motivations to innovate, including their: Alignment with and support for an organisation's governance framework, risk management approach, and ethical values Ability to understand, develop and implement an organisation's strategy Loyalties and motivations for improving processes, goods and services, including their ability to lead, manage and collaborate
5. Social and relationship capital	The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being. Social and relationship capital includes: Shared norms, and common values and behaviours Key stakeholder relationships, and the trust and willingness to engage that an organisation has developed and strives to build and protect with external stakeholders Intangibles associated with the brand and reputation that an organisation has developed An organisation's social licence to operate
6. Natural capital	All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organisation. It includes: Air, water, land, minerals and forests Biodiversity and eco-system health

Not all capitals are equally relevant or applicable to all organisations. While most organisations interact with all capitals to some extent, these interactions might be relatively minor or so indirect that they are not important enough to include in the integrated report.

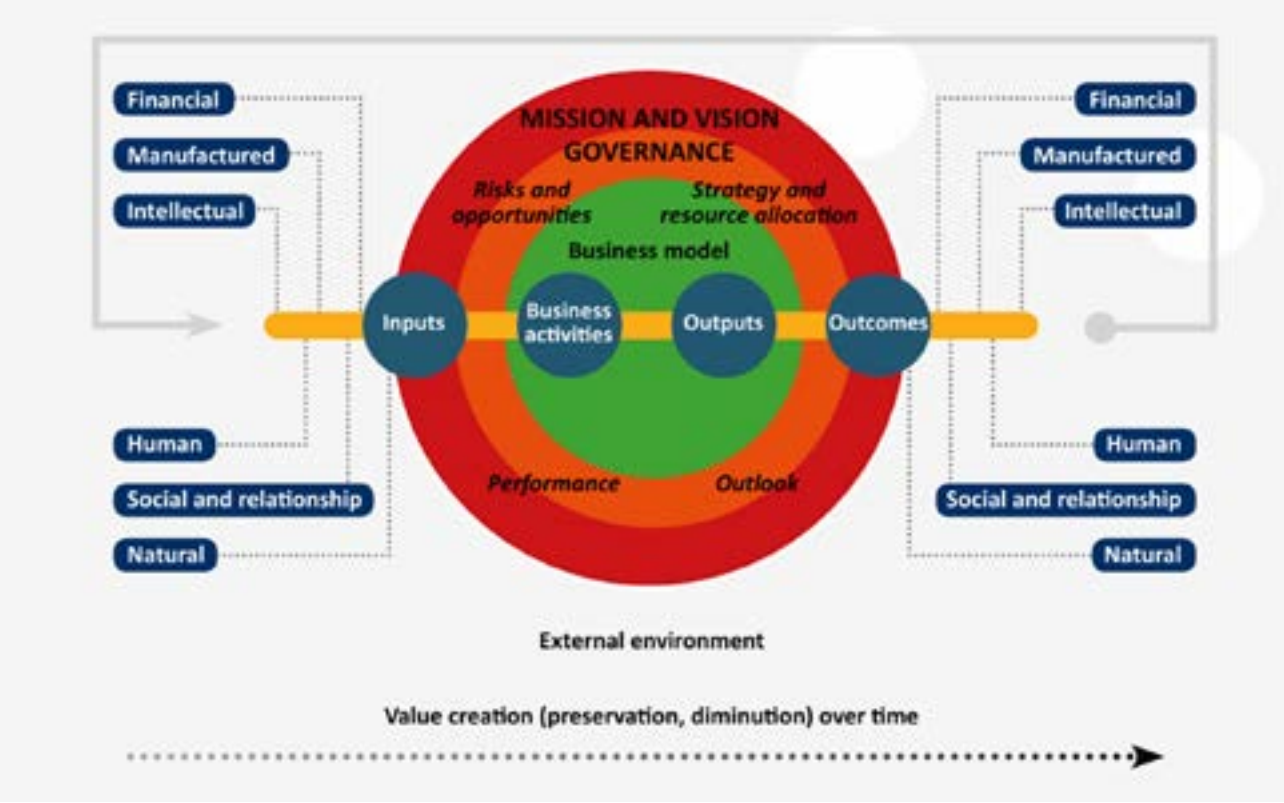
3.3.3 Content Elements

The content elements are the areas that the integrated report should include. An integrated report includes eight elements that are fundamentally linked to each other and are not mutually exclusive:

1. **Organisational overview and external environment**. What does the organisation do and what are the circumstances under which it operates?
2. **Governance**. How does the organisation's governance structure support its ability to create value in the short, medium and long term?
3. **Business model**. What is the organisation's business model?
4. **Risks and opportunities**. What are the specific risks and opportunities that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?
5. **Strategy and resource allocation.** Where does the organisation want to go and how does it intend to get there?
6. **Performance.** To what extent has the organisation achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?
7. **Outlook.** What challenges and uncertainties are the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?
8. **Basis of presentation.** How does the organisation determine what matters to include in the integrated report and how are such matters quantified or evaluated?

3.3.4 Summary

The figure below illustrates the different factors that interact to create value in a company:



Source: ***https://www.integratedreportingsa.org/ircsa/wp-content/uploads/2017/05/SAICAIntegratedThinkingLandscape.pdf***

As you can see, the process by which inputs are translated into outcomes is circular because the integrated report itself allows companies to make decisions about how to apply the inputs in future periods. All activity should be directed to achieving the company's strategic goals, symbolised in its stated mission and vision. And the process should be overseen and managed by the corporate governance function of the company, usually its board.

Integrated reporting supports improved corporate governance, because it provides richer, more internally coherent information about company operations to those charged with governance, allowing them to see the impact of decisions across a wider range of outcomes than normally envisioned in corporate reporting. Indeed, in some jurisdictions, such as South Africa, for Example, mandatory codes of corporate governance include the requirement to prepare an integrated report, with specific rules about disclosures.

Summary of Unit C and key learning outcomes

In this unit, we looked at the following learning outcome:

Learning Outcome	
Development and presentation of financial and non-financial information. Financial information	Building on the knowledge gained during Financial Reporting, you should now be aware of how to develop and present a wide range of financial and non-financial information about an organisation's performance. You should also be able to explain how corporate reporting is developing, and the wide range of converging reporting platforms that are being increasingly adopted, particularly in developed economies.
Disclosure of financial information in the public sector	
Non-financial information	

Quiz questions

1	C.1
If a GPI for a country shows the following rates, what is the conversion factor at 31 Dec 20X5 for items acquired in 20X3? 20X3 – 90 20X4 – 160 20X5 – 240	
	1.77
	0.37
	1.50
	2.66

2	C.1
If the company illustrated above reported quarterly, what would be the correct comparator for the Statement of Profit or Loss for quarter 3 20X5 (choose one):	
A	31 December 20X4
B	30 September 20X4
C	30 June 20X4
D	31 March 20X4

3	C.1
Which one of the following companies is not normally a related party to Company A, under IAS 24?	
	Company Z's audit committee is chaired by Company A's finance director
	Company P operates Company A's defined benefit pension plan

	Company L is owned by the CEO of Company A
	Company J is a joint venture between Company A and Company T

4	**C.1**
Which one of the following statements is false in respect of the application of IFRS 8?	
	Companies should report segment depreciation for relevant assets
	Operating segments with 10% of the company's assets are reporting segments
	Amounts reported under segments should be reconciled to the financial statements
	Reporting segments must contribute at least 75% of the company's total revenue

5	**C.2**
Which one of the government owned entities below should be categorised as part of the public non-financial corporation sector?	
	Ministry of Defence
	The Central Bank
	The Postal Service
	The Customs Agency

6	**C.3**
In terms of the information to include in management commentary, which of the following is not a requirement of the IFRS Practice Statement 1 (choose one):	
A	Information should be forward looking

B	Information should be consistent with the conceptual framework
C	Information should be incorporated into the financial statements
D	Information should be relevant to management

7	**C.3**
Which of the capitals should a company's brand value be categorised under (choose one):	
A	Financial capital
B	Intellectual capital
C	Human capital
D	Social capital

Unit D: Financial Reporting Issues

Learning outcomes

D.1 Non-current and current assets
D.2 Financial instruments
D.3 Employee rewards
D.4 Liabilities
D.5 Revenue and income
D.6 Fair value measurement
D.7 Financial reporting for specific industries within the private sector
D.8 Financial reporting for small and medium-sized entities
D.9 Accounting for transactions in the public sector

Introduction to Unit D

This Unit will expand on the knowledge you gained in Financial Reporting Unit C, which introduced financial reporting issues relating to fixed assets and other key elements of the financial statements. The specific learning objective in accordance with the syllabus is to apply professional judgement in order to develop appropriate accounting policies for complex financial reporting issues in corporate entities and public sector organisations. The intention is thus to build on that core knowledge by taking into consideration more complex aspects of financial reporting.

D.1 Non-Current and Current Assets

The contents of this section of the Unit were introduced in Financial Reporting, so you will find that each heading will include some material to refresh the knowledge previously gained as well as new aspects of asset accounting that were not previously encountered.

1.1 Non-Current Assets: Property Plant and Equipment (PPE)

1.1.1 Introduction

In Financial Reporting we learned that the main standards relating to PPE are IAS 16 and IPSAS 17, which are similar in scope but have some notable differences that we will explore in more detail here.

The definition of PPE according to IAS 16 is as follows:

Property, plant and equipment are tangible items that:

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

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

The key point here is that PPE contributes to the operations of the business, and this can include, for Example, machines used to build the company's main product, as well as the office furniture used by the HR department in managing the employees who operate those machines.

Financial Reporting introduced you to the distinction between tangible and intangible assets. Tangible assets are having a physical existence and refers to assets like equipment, land, buildings and vehicles; whereas intangible assets refer to assets which do not have a physical existence and are not financial. Examples of intangible assets include patents, internally developed software, and goodwill. There are however some types of tangible asset which fall under this definition but are not covered by IAS 16, as these assets have specific standards to address their particular characteristics. IAS 16 notes that the standard does not apply to:

(a) Property, plant and equipment classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

(b) Biological assets related to agricultural activity other than bearer plants (see IAS 41 *Agriculture*). IAS 16 applies to bearer plants but it does not apply to the produce on bearer plants.

(c) The recognition and measurement of exploration and evaluation assets (see IFRS 6 *Exploration for and Evaluation of Mineral Resources*).

(d) Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources (see IFRS 6 *Exploration for and Evaluation of Mineral Resources*).

However, IAS 16 applies to property, plant and equipment used to develop or maintain the assets described in (b) – (d).

So, IAS 16 applies to the grape vines (bearer plants), but not the grapes, since the grapes are covered by IAS 41 (see section D7, below for more information). It also applies to the tractors or other equipment used to harvest the grapes. Assets held for sale are not covered because IAS 16 is concerned with assets which are used in business operations, and assets held for sale, along with assets relating to discontinued operations, are specifically taken out of operations so that they can be quickly disposed of. 1.1.2 Initial Recognition of PPE

As you learned in Financial Reporting, an item of property, plant and equipment can be recognised as an asset when:

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

(b) The cost of the item can be measured reliably.

IAS 16 does not prescribe the unit of measure for recognition, i.e. what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances.

This latter paragraph means that an entity should develop its own accounting policy defining what is reported as PPE, based on its situation. The standard suggests for Example,

that many small but important PPE items could be aggregated together into a single class, and the total value reported, using the standard's criteria.

You were also introduced in Financial Reporting to the way that cost can be calculated when recognising PPE for the first time (the initial measure). The initial measure (cost) of an item of property, plant, and equipment comprises of:

(a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) Where applicable, the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired, or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period (also covered under IAS 37 ***Provisions, contingent liabilities and assets***).

Examples of directly attributable costs are:

(a) Costs of employee benefits (as defined in the relevant international or national accounting standard dealing with employee benefits) arising directly from the construction or acquisition of the item of property, plant, and equipment;

(b) Costs of site preparation;

(c) Initial delivery and handling costs;

(d) Installation and assembly costs;

(e) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) Professional fees.

The first step in recognising PPE in the accounts therefore, is to accurately identify and measure all the costs incurred in enabling it to operate productively.

One important additional component of the cost of PPE which must be capitalised was explored in Financial Reporting and will therefore only be briefly referred to here: borrowing costs directly attributable to an asset being brought into productive use. The relevant standard for borrowing costs, IAS 23 ***Borrowing costs***, requires that borrowing costs directly attributable to the acquisition, construction or production of a 'qualifying asset' (one that necessarily takes a substantial period of time to get ready for its intended use or sale) are included in the initial cost of the asset. Other borrowing costs are recognised as an expense.

1.1.3 Component Accounting

Large items of property, plant and equipment often comprise multiple parts with varying useful lives or consumption patterns and IAS 16 requires companies to separately depreciate those parts that are significant. This is because those significant parts (referred to as components) may need to be periodically replaced or overhauled during the useful

life of the larger asset, with the result that the components will have different useful lives. They may also have a different pattern of consumption, meaning that the respective accounting policy may apply, for Example, straight line depreciation to one component and reducing balance to another. A common Example used to illustrate this requirement relates to aircraft: the body of an aircraft will typically be valued and depreciated separately to the engines, because the engines comprise a significant proportion of the value of the aircraft and would usually have a shorter useful life.

Specifically, IAS 16 states that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

So, where it is possible to identify distinct material components of an asset, whether purchased or constructed, with different useful lives, those components should be recognised separately. Further, upon replacement or overhaul of a component, the company is required to capitalise the cost and derecognise the carrying amount of the replaced component.

In terms of disclosure, IAS 16 requires that the Statement of Financial Position shows the aggregated total for PPE and not the individual components that make up the assets recorded under PPE. The objective of the component approach is to more precisely reflect the pattern in which the asset's future economic benefits are expected to be consumed by the company. However, component accounting can have a significant impact on the depreciation charge borne by the company, as the Example below demonstrates:

1.1.4 Subsequent Measurement of PPE

You learned in Financial Reporting that, following initial recognition of PPE, an entity must consider how an asset's value has changed at the end of each subsequent reporting period. IAS 16 provides two models which companies can choose to apply, based on the characteristics of the asset: the Cost Model and the Revaluation Model.

Both models define a "carrying value" for each asset, and both measure that value taking account of any depreciation or impairment losses incurred since initial recognition. As the name suggests, the Cost Model uses the initial recognised cost as the basis for the carrying amount throughout the asset's useful life; whereas the Revaluation Model uses fair value, which is based on the value that could be obtained for the asset were it to be sold.

The key features of each model were explained in Financial Reporting and have been summarised in the table below:

Cost Model	Fair Value Model
The asset is carried at cost less accumulated depreciation less impairment losses	The asset is carried at fair value less accumulated depreciation less impairment losses. Fair value is the price that would be received to sell an asset in an orderly transaction between market participants. The fair value of the asset is normally determined by a professionally qualified valuer and is usually the market value of the asset. Revaluations should be made with sufficient regularity, depending on the volatility of the fair value of the asset, so that the carrying amount of an asset does not differ materially from its fair value at the reporting date. If one item of property, plant and equipment is revalued then all the items in that particular class of asset should be revalued. When a company chooses to revalue their non-current assets for the first time this is a change in accounting policy. However, IAS 16 **does not** require a retrospective adjustment.

The advantages and disadvantages of the two models are described in the table below:

Cost Model		Fair Value Model	
Advantages	**Disadvantages**	**Advantages**	**Disadvantages**
· Simple to understand and apply. · Reflects the full costs incurred in bringing the asset into productive use.	· Assets can remain in use after being fully depreciated. · The sale value of assets will not match the carrying value. · Still subject to impairment.	· Asset values can rise based on market conditions. · May provide a more accurate representation of the asset's actual value. · Eliminates fully depreciated assets remaining in use.	· Complex to apply and more subjective. · May require additional expense to value the assets. · Asset values can be volatile, irrespective of underlying productivity. · Increased asset values may result in increased depreciation charges.

The choice of model to adopt for a specific class of assets should therefore reflect operational or strategic priorities, for Example, if you have a factory full of highly specialised

machines which you have no intention of selling the cost model may be the most appropriate. A company which regularly sells its assets because of rapid technological change, on the other hand, may wish to use the fair value model so that selling price is closer to carrying value.

Another relevant factor is the overall picture that each model presents of the company's productive assets, for Example, a company which has to regularly recycle credit lines will want to have as valuable an asset base as possible, in order to satisfy lenders that it has sufficient collateral to offset its borrowing, and is therefore more likely to choose the fair value model.

A capitalised asset represents deferred expenses in that the costs allocated to the Statement of Financial Position are not recognised immediately in profit and loss. Depreciation is the process by which these deferred expenses are gradually recognised in profit and loss over the useful life of the asset. It should be noted that while useful life is normally measured in years, in a manufacturing or similar environment the useful life may refer to a specific number of production runs. If this is the case, the company will need to estimate the number of such runs that occur in each reporting period in order to translate that usage into a financial value.

Key Asset Definitions

Fair value is the price that would be received to sell an asset in an orderly transaction between market participants.

The **Useful life** of an asset is:

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

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

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

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

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

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

The **Recoverable amount** is the higher of an asset's fair value less costs of disposal and its value in use.

Value in use is the expected future cash flows that the asset in its current condition will produce, discounted to present value using an appropriate discount rate.

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

1.1.5 Revaluation

Revaluations of an asset can result in revaluation adjustments representing changes in the value of fixed assets that reflect the market value of the asset. The revaluation model requires periodic revaluation using an appropriate expert or method, for Example a company can undertake revaluations of its property portfolio every three years, and in the intervening periods it can revalue other asset classes like machinery and vehicles. The key points are 1) to revalue a class as a whole as defined in the respective accounting policy (without for Example cherry picking only those assets which you know have increased in value); and 2) to undertake such revaluations according to a fixed schedule.

Revaluations are dealt with as follows:

- any **increase** in value is credited to a revaluation reserve, via Other Comprehensive Income.
- any **reduction** in value is recognised as an expense in the statement of financial performance (although a decrease which reverses part or all of a previous increase for the same asset is debited to the revaluation reserve).

This requirement means that negative changes in value (which are really impairments, see below) are recognised as an expense at the time of recognition, although any revaluation reserve previously created should be written down first. Positive increases, on the other hand, are recognised in Other Comprehensive Income before being transferred to the Statement of Financial Position. Hence revaluations cannot be used to manipulate company earnings.

An increase in an asset's value, the revaluation surplus, is credited to the revaluation reserve in the statement of financial position using the following entry:

Debit: Property, plant and equipment

Credit: Other Comprehensive Income

Any decrease in value on revaluation should be recognised as an expense except where it offsets a previous increase on the same asset that had been recognised as a revaluation surplus. Any decrease greater than the revaluation surplus must be taken as an expense to profit or loss:

Debit: Revaluation reserve

Debit: Expense (excess)

Credit: Property, plant and equipment

A negative revaluation reserve cannot be created. The revaluation decrease must also be shown in other comprehensive income.

IAS 16 prohibits the reclassification of a revaluation surplus to the profit or loss. The revaluation surplus should be transferred from the revaluation reserve to retained earnings when the surplus is realised, i.e. when the asset is retired from use or disposed of:

Debit: Revaluation reserve

Credit: Retained earnings

This transfer between Statement of Financial Position accounts is shown in the statement of changes in equity.

1.1.6 Derecognition of PPE

According to IAS 16, the carrying amount of an item of property, plant, and equipment shall be derecognised:

(a) On disposal; or

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

The gain or loss arising from the derecognition of a PPE asset is equal to the difference between the net disposal proceeds, if any, and the carrying amount of the asset. This gain or loss is included in profit or loss when the asset is derecognised, but cannot be classified as revenue because it does not arise from normal operations.

1.1.7 Disclosure of PPE

According to IAS 16, the financial statements shall disclose, for each class of property, plant and equipment:

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

(b) the depreciation methods used;

(c) the useful lives or the depreciation rates used;

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

(e) a reconciliation of the carrying amount at the beginning and end of the period showing:

  (i) additions;

  (ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;

  (iii) acquisitions through business combinations;

  (iv) increases or decreases resulting from revaluations and from impairment losses recognised or reversed in other comprehensive income in accordance with IAS 36;

  (v) impairment losses recognised in profit or loss in accordance with IAS 36;

  (vi) impairment losses reversed in profit or loss in accordance with IAS 36;

  (vii) depreciation;

  (viii) the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and

  (ix) other changes.

Items a) to d) are typically disclosed in the accounting policies for PPE, whereas item e) will comprise a specific note showing the breakdown of PPE to reflect the various movements required. The table below provides an Example of the kind of disclosure note that is used to reconcile fixed asset opening and closing balances:

	Land	Buildings	Equipment	Total
	000	000	000	000
Cost or Valuation				
As at 1 January 20X4	650	8 100	500	9 250
Revaluations	250	0	0	250
Additions	0	300	100	400
Disposals	0	(150)	(50)	(200)
As at 31 December 20X4	900	8 250	550	9 700
Accumulated Depreciation				
As at 1 January 20X4	0	730	100	830
Disposals	0	(40)	(22)	(62)
Charge for the year	0	206	118	324
As at 31 December 20X4	0	896	196	1 092
Carrying Value				
As at 1 January 20X4	650	7 370	400	8 420
As at 31 December 20X4	900	7 354	354	8 608

1.2 Non-Current Assets: Assets held for sale, Intangible Assets, Investment Property and Other Investments

1.2.1 Non-current assets held for sale

You will recall from Financial Reporting that this standard relates to assets which a company decides to take out of operation and sell. There are a number of consequences to doing this in terms of the value that the asset will then represent for the company, and the associated cash flows.

The following conditions must be met for an asset (or disposal group) to be classified as held for sale:

- Management is committed to a plan to sell
- The asset is available for immediate sale
- An active programme to locate a buyer is initiated
- The sale is highly probable, within 12 months of classification as held for sale
- Actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

It is possible that a held for sale asset may remain on an entity's statement of financial

position beyond one year, if the prolongation of the selling period is extended by events or circumstances beyond the control of the entity, and the entity remains committed to the sale. **An asset that is to be abandoned should not be classified as held for sale**.

A disposal group held for sale is a group of assets, possibly with associated liabilities, which an entity intends to dispose of in a single transaction. For Example, if a business is selling off a factory that contains equipment, inventory etc.

At the time of classification as held for sale (i.e. immediately before the initial classification of the asset as held for sale), the carrying amount of the asset will be measured in accordance with applicable IFRSs. For Example, property, plant and equipment will be measured in accordance with IAS 16.

After classification as held for sale – assets (or disposal groups) held for sale are measured at the lower of carrying amount and fair value less costs to sell.

Assets (or disposal groups of assets) held for sale are not depreciated because they are not in use. If the value deteriorates due to poor storage, for Example, this should be reflected in the valuation, and the corresponding entry on the statement of profit or loss.

A non-current asset (or disposal group of assets held for sale) that is no longer classified as held for sale (for Example because the sale has not taken place within one year) is measured at the lower of:

- Its carrying amount before it was classified as held for sale, adjusted for any depreciation that would have been charged had the asset not been held for sale; and
- Its recoverable amount at the date of the decision not to sell.

Assets (or disposal groups) held for sale must be presented separately on the face of the statement of financial position under 'current assets'.

An impairment loss should be recognised where fair value less costs to sell is lower than carrying amount. Impairment may be reversed if the fair value of the asset increases, but only to the extent of impairment losses already recognised for the asset.

1.2.2 Disclosures

The following disclosures are required by IFRS 5:

- Description of the non-current asset or disposal group
- Description of facts and circumstances of the sale and expected timing
- Impairment losses, if any
- If applicable, the reportable segment in which the asset (or disposal group) is presented in accordance with IFRS 8 Operating Segments.

1.2.3 Intangible Assets

You covered IAS 38 Intangible Assets in depth in Financial Reporting, so this section will simply refresh the key points. As you will recall, this standard specifies the criteria that determine when an intangible asset can be recognised, how to measure its carrying value and explain the disclosure requirements.

An intangible asset is an identifiable non-monetary asset without physical substance. In other words, it is intangible and it is not money.

An asset is identifiable if it is either:

- Separable, which means capable of being separated or divided from the entity, regardless of whether the entity intends to do so; or
- Arises from contractual or other legal rights.

Intangible assets include:

- Development costs – costs of developing a new product, material or system.
- Copyrights
- Patents
- Brands
- Licences
- Franchises
- Purchased goodwill

1.2.4 Research and Development

The standard requires entities to distinguish whether an activity represents research or development, since the former should be expensed while it may be possible to capitalise the latter. The Financial Reporting workbook included the following table which explains the different characteristics and treatment of research and development accounting:

Research	Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.	Research costs are written off as incurred as an expense in the profit or loss. Research costs fail the definition of an asset as probability of future economic benefit cannot be measured.
Development	The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production.	Development costs are capitalised as an intangible asset when specific criteria are met (see below for criteria). Development costs are written off as incurred to the SCI as an expense unless it meets the specific criteria for capitalisation. If the criteria are met then the costs must be capitalised from that point as an intangible asset and amortised over the useful life of the asset once production / commercial benefits commence. Costs incurred prior to the criteria being met are expensed.

The criteria that must be met before development costs can be capitalised are:

- Sellable or useable by the entity

- Technical feasible to complete it such that it can become sellable or usable
- Economic benefits must be expected to flow to the entity from the development of the intangible asset.
- Measurable expenditure. The entity can determine the costs incurred in developing the intangible asset.
- Intention to complete. The entity must be able to demonstrate its intention to complete the development of the intangible asset.
- Completable. The entity can demonstrate it has adequate technical, financial, and other resources to complete the development of the intangible asset.

An asset must meet all these criteria if it is to be recognised as an intangible development asset.

1.2.5 Other Intangibles

Other intangibles include:

- Copyrights and patents
- Licenses
- Franchises
- Computer software
- Brands* (see note below)
- Mastheads (of newspapers)*
- Publishing titles*
- Customer lists*

**Note – These intangibles will only be recognised if they are purchased from a third party.*

As with development costs there are criteria which have to be met before an entity can recognise other intangible assets.

1.2.6 Recognition

An intangible asset, when recognised initially, must be measured at cost. It should be recognised if, and only if, **both** of the following occur:

- It is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- The costs can be measured reliably.

The cost of an internally generated intangible asset is the expenditure incurred from the date when the intangible asset first meets the recognition criteria. Costs prior to this point must be expensed.

1.2.7 Amortisation

IAS 38 requires that intangible assets are amortised over their useful life. Amortisation is the term used for the depreciation of an intangible noncurrent asset.

1.2.8 Finite life assets

An intangible asset with a finite useful life should be amortised over its expected useful life.

- Amortisation should start when the asset is available for use.
- Amortisation should cease at the date that the asset is derecognised.
- The amortisation method used should reflect the pattern in which the asset's future economic benefits are consumed. If such a pattern cannot be predicted reliably, the straight-line method should be used.
- The amortisation charge for each period should normally be recognised as an expense.

The residual value of an intangible asset with a finite useful life is assumed to be zero, although there can be exceptions.

The amortisation period and the amortisation method used for an intangible asset with a finite useful life should be reviewed at each financial year end.

1.2.9 Indefinite useful life assets

An intangible asset with an indefinite useful life should **not** be amortised. In accordance with IAS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount:

- annually, and
- whenever there is an indication that the intangible asset may be impaired.

1.2.10 Subsequent Measurement

Consistent with the treatment of tangible non-current assets, there are two methods of valuing intangible assets: the cost and revaluation model.

Applying the **cost model**, an intangible asset should be carried at its cost, less any accumulated amortisation and less any accumulated impairment losses. This is consistent with the treatment of the cost model for tangible non-current assets.

The **revaluation model** allows an intangible asset to be carried at a revalued amount, which is its fair value at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. The revaluation model can only be applied under the following circumstances:

- The fair value must be measurable reliably with reference to an **active market** in that type of asset
- The entire class of intangible assets of that type must be revalued at the same time
- If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset should be carried at its cost less any accumulated amortisation and impairment losses
- Revaluations should be made with such regularity that the carrying amount does not differ materially from that which would be determined using fair value at the date of the statement of financial position.

Many intangible assets are developed to meet the specific needs of the companies that hold them, and hence there do not tend to be many active markets for them. The Examples of intangibles provided by the standard that could meet this requirement comprise fishing and taxi licenses, which are usually transferrable and hence could be traded. The accounting treatment for revaluations is consistent with that of revaluations of property, plant and equipment under IAS 16.

1.2.11 Derecognition

An intangible asset should be eliminated from the statement of financial position when it is disposed of, or when there is no further expected economic benefit from its future use or disposal.

This treatment is no different from that for property, plant and equipment as specified by IAS 16.

1.2.12 Disclosures

IAS 38 requires specific disclosures for each class of intangible asset, as follows:

- useful life or amortisation rate
- amortisation method
- gross carrying amount
- accumulated amortisation and impairment losses
- line items in the income statement in which amortisation is included
- reconciliation of the carrying amount at the beginning and the end of the period showing:
    - additions (business combinations separately)
    - assets held for sale
    - retirements and other disposals
    - revaluations
    - impairments
    - reversals of impairments
    - amortisation
    - foreign exchange differences
    - other changes
    - basis for determining that an intangible has an indefinite life
    - description and carrying amount of individually material intangible assets
    - certain special disclosures about intangible assets acquired by way of government grants
    - information about intangible assets whose title is restricted
    - contractual commitments to acquire intangible assets

IAS 38 requires additional disclosures, where relevant, about intangible assets carried at revalued amounts and the amount of research and development expenditure recognised

as an expense in the current period.

1.2.13 Investment Properties

IAS 40 and IPSAS 16 (both titled *Investment properties*) prescribe the accounting treatment for investment properties and related disclosure requirements.

An investment property is property (land or a building, or part thereof) held by the owner to earn rentals or for capital appreciation rather than for:

- Use in the production or supply of goods or services or for administrative purposes; or
- Sale in the ordinary course of business.

IAS 40 lists the following as Examples of an investment property:

- Land held for long-term capital appreciation rather than short-term sale
- Land held for a currently undetermined future use
- A building owned by the entity (or a right-of use asset relating to a building held by the entity) and leased to a third party under an operating lease
- A building which is vacant but is held to be leased out under an operating lease
- Property being constructed or developed for future use as an investment property.

IAS 40 also provides the following Examples of items that are **not** investment property;

- Property intended for sale in the ordinary course of business
- Property being constructed on behalf of a third party
- Owner occupied property
- Property leased to another entity under a finance lease.

Investment properties are initially recognised in the statement of financial position at cost (using the same guidelines as the initial cost of an item of property, plant and equipment under IAS 16 or IPSAS 17).

They are subsequently recognised by one of two methods, fair value or using the cost model. The choice of method should depend on the purpose for which the asset is held. The more long-term the plans are, the more likely that the cost model is more appropriate. Fair value provides the distinct benefit of foregoing depreciation, and is more appropriate where an asset is expected to appreciate in value, or where there is a mid-term plan to sell it. The method is an accounting policy and therefore the same model has to be applied to all investment properties.

Cost model

Under the cost model, the entity recognises the investment properties in exactly the same way as under IAS 16 Property, Plant and Equipment (or under IPSAS 17 in the public sector). An additional disclosure of the fair value of the properties must be made. The asset must be depreciated over its useful life.

1.2.14 Fair value model

The fair value model involves recognising the investment properties at fair value, this being the amount that would be received to sell an asset in an orderly transaction. Any

movement in the fair value of the asset results in a gain or loss being recognised directly in profit or loss as income/expense. The assets are not depreciated, as the movements recorded in profit and loss reconcile to the changes in the balance's value.

1.2.15 Additional Classification Issues

There are some classification issues that arise under IAS 40 that were not covered in Financial Reporting. These relate to situations where the use of the asset is more complex.

Property held under an operating lease

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property provided that:

- The rest of the definition of investment property is met
- The operating lease is accounted for as if it were a finance lease in accordance with IFRS 16 *Leases*
- The lessee uses the fair value model set out in the standard for the asset recognised

This type of situation could arise where a company leases a large plot and has the right to sub lease a defined portion of it. If the sub-leased plot met the requirements of IAS 40 it would be possible to classify it as an investment property. An entity may make the foregoing classification on a property-by-property basis, rather than by class.

Partial own use

If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. Therefore, the part that is rented out is investment property. If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant.

Ancillary services

If the entity provides ancillary services to the occupants of a property held by the entity, the appropriateness of classification as investment property is determined by the significance of the services provided. If those services are a relatively insignificant component of the arrangement (for instance, the building owner supplies security and maintenance services to the lessees), then the entity may treat the property as investment property. Where the services provided are more significant (such as in the case of an owner-managed hotel), the property should be classified as owner-occupied.

Intracompany rentals

Property rented to a parent, subsidiary, or fellow subsidiary is not investment property in consolidated financial statements that include both the lessor and the lessee, because the property is owner-occupied from the perspective of the group. However, such property could qualify as investment property in the separate financial statements of the lessor, if the definition of investment property is otherwise met.

1.2.16 Transfers to/from investment property

It may be necessary to transfer property out of investment property because a change

in use means it no longer meets the definition requirements, or because usage changes in terms of the classification issues noted above. Company D, from the Example above, could decide to expand its own use of the investment property and reduce the proportion leased out. In that case the investment property may no longer be separable, and the proportion occupied by the owner may become significant. The reverse situation could of course apply, where property classed as PPE ceases being used for operational purposes. Transfers to or from investment property should therefore only be made when there is a change in use.

The following rules apply for accounting for transfers between categories:

- When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.
- For a transfer from investment property carried at fair value to owner-occupied property or inventories, the fair value at the change of use is the 'deemed cost' of the property under its new classification.
- For a transfer from owner-occupied property to investment property carried at fair value, IAS 16 should be applied up to the date of reclassification. Any difference arising between the carrying amount under IAS 16 at that date and the fair value is dealt with as a revaluation under IAS 16.

What this means is that cost model investment properties are simple to transfer as there will be no adjusting entries whether it is used for investment, owner-occupied, or listed for sale. This is because cost is measured in the same way for all three types of classification.

Where a company uses fair value for its investment properties, an adjustment may need to be made if it is transferring an asset between PPE and investment property. This is because the carrying value under IAS 16 may not be the same as the fair value under IAS 40. Any difference will be recognised as a revaluation, which means that any reduction in value can be debited to the revaluation reserve (if one exists for this asset) before the balance is recognised as an expense.

1.2.17 Disclosures

IAS 40 requires companies holding investment properties to disclose the following:

- Choice of fair value model or cost model
- Criteria for classification as investment property
- Use of independent professional valuer (encouraged but not required)
- Rental income and expenses
- Any restrictions or obligations.

Additional disclosures relate to the fair value and cost models:

- An entity that adopts the fair value model must also disclose a reconciliation of the carrying amount of the investment property at the beginning and end of the period.
- An entity that adopts the cost model must disclose information on the depreciation method that is applied. In addition, an entity which adopts the cost model must disclose the fair value of the investment property.

1.2.18 Differences between IAS 40 and IPSAS 16

IAS 40 and IPSAS 16 are very similar in scope, definitions, and in the required accounting treatments. You learned in Financial Reporting that there are two exceptions to this: IPSAS 16 specifies that where an asset is acquired for no cost (e.g. as a donation) or for a nominal cost, its cost is its fair value at the date of acquisition. IPSAS 16 also does not apply to property held to deliver a social service that also generates cash inflows.

It should be noted that many public sector entities hold commercial properties which they rent out at below the market rate in order to stimulate economic activity by providing subsidised facilities to private sector companies. Such properties are not investment properties because the primary purpose of holding them is to deliver services, rather than to generate revenue or sell. Where a public sector entity charges market rates it will be more appropriate to classify the property under IPSAS 16.

1.2.19 Investments in subsidiaries, associates and joint ventures

You were introduced to subsidiaries, associates and joint ventures in some depth in Unit D of Financial Reporting and should be familiar with the way that ownership interests in related companies are recognised and measured in financial statements. A company that makes an investment in a related company needs to recognise the value of that investment in its own statement of financial position, as well as any changes in value that arise. The key terms are defined in IAS 28 as follows:

Associate	An entity over which the investor has significant influence
Significant Influence	The power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies (usually taken as >20% ownership).
Joint Arrangement	An arrangement of which two or more parties have joint control.
Joint Control	The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
Joint Venture	A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
Joint Venturer	A party to a joint venture that has joint control of that joint venture.

The accounting requirements are set out in IAS 28, and you learned earlier in Financial Reporting that once investments have been recognised, they are measured using the Equity Method. This is a simplified form of consolidation in that the investee's financials are not incorporated line-by-line into the investor's financial statements. Instead, a single asset representing the equity-accounted investment is recognised in the statement of financial position. Similarly, single-line items are presented in the investor's P/L and OCI statements to represent its share of the investee's profit or loss and other comprehensive income. The key point is to apply the % ownership consistently to the investment's relevant financial results, and reflect any changes correctly in profit and loss or other comprehensive income.

An investment in an associate or a joint venture is generally classified as a non-current asset, unless it is classified as held for sale in accordance with IFRS 5.

One notable feature of accounting for equity investments relates to distributions of dividends, as these reduce the net assets of the investment and will thus reduce its value. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income (e.g. to account for changes arising from revaluations of property, plant and equipment and foreign currency translations.)

An entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and, generally, does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments. Instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with IFRS 9, as long as they do not give rise to any ownership interest.

IFRS 9 Financial Instruments does not apply to interests in associates and joint ventures that are accounted for using the equity method. An entity applies IFRS 9, including its impairment requirements, to long-term interests in an associate or joint venture where the equity method has not been applied.

There are very few circumstances under which IAS 28 allows a company to not use the equity method, and instead account for an investment as a financial instrument, using IFRS 9. The equity method will not apply for an investment under the following circumstances:

1. The entity is a parent that is exempt from preparing consolidated financial statements under IFRS 10 (typically because it will be consolidated in its own parent's accounts), or all of the following four conditions are met:
    a) The company is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners do not object to the investor not applying the equity method;
    b) The investor or joint venturer's debt or equity instruments are not traded in a public market;
    c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and;
    d) The ultimate or any intermediate parent of the parent produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.
2. When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust or similar, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with IFRS 9. The election is made separately for each associate or joint venture on initial recognition.
3. When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, or a mutual fund, unit trust and similar, the entity may elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with IFRS 9. If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in

an associate that is not held through this type of entity.

The measurement basis for investment thus uses the equity method, with no other accounting policy option, unless the investment meets the specific criteria above. The latter two exemptions should be understood as relating to the degree of control which the investor has, with FVTPL only being appropriate when the investment is held (whether in whole or in part) through a third party.

1.2.20 Recognition

According to IAS 28, investments accounted for under the equity method are initially recognised at cost and this cost at initial recognition should include:

- The fair value of the consideration transferred.
- Contingent consideration measured at fair value.
- The fair value of any previously held interest.
- Deferred tax effects related to the investor's share of the fair value of the associate's or joint venture's identifiable assets and liabilities.

Additionally, when an investment transitions from a consolidated subsidiary to an associate or joint venture, the cost for initial recognition is the fair value of the retained interest as of the date control is lost.

1.2.21 Other Costs

However, the costs allowed under IAS 28 are not consistent with the general IFRS approach, which requires assets not carried at fair value through profit or loss to be measured at cost at initial recognition. This cost includes expenditures directly attributable to the acquisition of the asset, such as legal fees, transfer taxes, and other transaction costs. As a result, many companies elect to include directly attributable costs in the cost of an investment in the investor's financial statements, including the accounting policies.

Any costs incurred prior to the actual acquisition of the asset can be recognised as prepayments and subsequently capitalised as part of the initial carrying amount of the investment at the acquisition date.

In September 2024, the IASB published an exposure draft proposing amendments to IAS 28 to address common application issues related to the equity method. With regard to changes in ownership interests, where the degree of control changes in relation to other investors, the 2024 exposure draft proposes that, when acquiring an additional ownership interest, an investor should:

- Recognise the additional ownership interest at the fair value of the consideration transferred.
- Include in the carrying amount of the investment the investor's additional share of the fair value of the associate's or joint venture's identifiable assets and liabilities.
- Account for any difference between these two amounts as either goodwill (included in the carrying amount of the investment) or as a gain from a bargain purchase recognised in P/L.

As the options above are in an exposure draft, it is unclear what the revised standard will say when issued, but exposure drafts usually do not vary very significantly from the final standard. The options present alternative ways of recognising an increase in ownership

interest, which means a greater claim on the net assets of the investment in proportion to its other owners. This could happen if one investor in an associate purchases some or all the shares held by another investor. The first option in the exposure draft would simply use the consideration paid for that increased claim (e.g. shares) as the value to be recognised on the statement of financial position.

The second option would increase the value of the investment by using the proportional claim of the investment's assets and liabilities as the basis for the increase. While the first option uses the amount paid by the investor, the second uses the actual value acquired in the transaction.

The third option would not increase the value of the investment at all, but instead recognise the increase as an asset through goodwill, or through profit and loss as a gain.

IAS 28 does not include any disclosure requirements; these are included in IFRS 12 *Disclosure of Interests in Other Entities*.

1.3 Impairment of Non-Current Assets

Financial Reporting explored accounting for asset impairments under IAS 36 *Impairment of assets* in some depth, so here we will be revising that material in summary as well as the specific impairment requirements of IPSAS.

The depreciated value of an asset at the reporting period is the value which recognises the extent to which the asset has been "consumed" in the normal course of business. As you saw in Financial Reporting, an asset can also be subject to abnormal loss of value, due to damage or poor maintenance, for Example. This type of reduction in value owing to a loss in productive capacity is called an impairment.

You learned in Financial Reporting that the aim of IAS 36 is to ensure that assets are carried at no more than their recoverable amount. Impairment losses occur when an asset's carrying value exceeds the value that the company can recover from its use.

The value in use of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its expected useful life. Expected outflows in respect of an asset will include regularly incurred expenses such as scheduled maintenance.

1.3.1 Testing for impairment

An entity must review its assets to look for indications of impairment at each reporting date. The indicators of impairment that should be used to conduct this review can arise from sources within the company or outside it and include the following:

External sources:

- Market value declines.
- Negative changes in technology, markets, economy, or laws.
- Increases in market interest rates (this will affect the rate of return).

Internal sources:

- Obsolescence or physical damage. For Example, inventory being damaged as a result of a flood or fire
- Asset is expected to be disposed of or no longer used

- Plans to discontinue the operation in which the asset is used
- Economic performance is lower than expected.

For those assets that show signs of impairment, an entity will undertake an impairment test to determine whether the carrying value of the asset exceeds the recoverable amount.

1.3.2 Cash Generating Units

It is not always possible to work out the value in use of every asset when determining impairments. For Example, a value in use could not be calculated for an individual piece of machinery in a factory because its productive potential arises from it operating as part of a larger system (hence alongside other assets). Therefore, IAS 36 requires that, in this Example, the assets of the whole factory to be tested for impairment as a cash generating unit.

A cash generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash flows from other assets or groups of assets.

1.3.3 Reversing an impairment

If the recoverable amount of an asset that was previously impaired returns above its post-impairment carrying value, the impairment may be reversed.

The new carrying value of the asset can be increased to the lower of the new recoverable amount and the carrying value that would have been if the impairment had never taken place. This ensures that the reversal will never be more than the original impairment.

Accounting for the reversal:

- The reversal is recognised in the statement of profit or loss (up to the extent that the initial impairment was recognised).
- Any amount remaining above the initial impairment is then treated as a positive revaluation in accordance with the accounting standard relevant to the class of asset. The remainder of the reversal is then recognised in the revaluation reserve (again up to the extent that the initial impairment was recognised in the revaluation reserve).
- Note that an impairment of Goodwill cannot be reversed.

To reverse an impairment the accounting entries are the reverse of what was posted for the original impairment.

1.3.4 Disclosure of Impairments

IAS 36 calls for substantial disclosure about impairment of assets. This is because impairments may be an important indicator of the company's sustainability: perhaps they are arising because management have cancelled maintenance to save cash, or because the assets the company uses to raise revenue are becoming obsolete. The information to be disclosed in the financial statements about impairments includes the following:

- For each class of assets, the amount of impairment losses recognised, and the amount of any impairment losses recovered (that is, reversals of impairment losses).
- For each individual asset or CGU that has suffered a significant impairment loss,

details of the nature of the asset, the amount of the loss, the events that led to recognition of the loss, whether the recoverable amount is fair value less costs of disposal or value in use, and if the recoverable amount is value in use, the basis on which this value was estimated (for Example the discount rate applied).

1.4 Current Assets: Inventory

One of the key measures of financial performance for many companies is their cost of sales, as this indicates how efficiently the production process in the company operates. It is a measure that directly impacts on cash flow and therefore liquidity, and for a set of similar companies like retailers, operating in a competitive market, it provides a very useful indicator of the relative quality of management. One of the key components of cast of sales is the cost of inventory, and this ties to the value of inventory held at reporting date. As was explained in Financial Reporting, in order to give a fair presentation of an organisation's profit for an accounting period and the assets held at the end of an accounting period, it is essential that inventory is properly valued.

IAS 2 *Inventories* provides guidance for determining the cost of inventories and for subsequently recognising an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Inventories include assets held for sale in the ordinary course of business (finished goods), assets in the production process for sale in the ordinary course of business (work in process), and materials and supplies that are consumed in production (raw materials).

However, IAS 2 excludes certain inventories from its scope:

- Work in process arising under construction contracts
- Financial instruments
- Biological assets related to agricultural activity and agricultural produce at the point of harvest

Also, while the following are within the scope of the standard, IAS 2 does not apply to:

- The measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value (above or below cost) in accordance with well-established practices in those industries. When such inventories are measured at net realisable value, changes in that value are recognised in profit or loss in the period of the change.
- Commodity brokers and dealers who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognised in profit or loss in the period of the change.

IAS 2 *Inventories* and IPSAS 12 *Inventories* are similar in scope and in terms of the main accounting requirements for inventories, but the following differences can be noted:

- IPSAS 12 includes guidance on the treatment of inventories that may be distributed at no charge or for a nominal charge.
- IPSAS 12 includes a definition of current replacement cost.
- IPSAS 12 requires the cost of inventories acquired through non-exchange transactions to be based on their fair value at acquisition.

- IPSAS 12 requires inventories provided at no charge or for nominal charge are to be value at the lower of cost and current replacement cost.

A central requirement of both IAS 2 and IPSAS 12 is that inventories should be valued at the lower of cost and net realisable value (NRV). NPV will include costs necessary to complete and sell the inventory.

This valuation is in accordance with the accounting concept of prudence and is applied to items or groups of similar items separately.

1.4.1 Measuring inventory – cost

The cost of inventory comprises:

- Purchase price
- Costs of conversion
- Other costs incurred in bringing inventory to its present location and condition

Costs of conversion include:

- Costs directly related to the units of production, for Example direct materials, direct labour.
- Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, for Example the cost of factory management and administration.

IAS 2 emphasises that fixed production overheads must be allocated to items of inventory on the basis of the normal capacity of the production facilities. This is an important point, and IAS 2 stipulates the following:

- Normal capacity is the expected achievable production based on the average over several periods/seasons, under normal circumstances.
- This figure should take account of the capacity lost through planned maintenance.
- If it approximates to the normal level of activity then the actual level of production can be used.
- Low production or idle plant will not result in a higher fixed overhead allocation to each unit because unallocated overheads must be recognised as an expense in the period in which they were incurred.
- When production is abnormally high, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.
- The allocation of variable production overheads to each unit is based on the actual use of production facilities.

1.4.2 Other costs

Any other costs should only be recognised as inventories if they are incurred in bringing the inventories to their present location and condition. Other costs include:

- Carriage inwards i.e. the cost of goods being delivered to the company.
- Import duties.

- Other handling costs.

The following costs are excluded from inventory valuation:

- Selling costs.
- General administrative overheads.
- Storage costs (unless necessary before a further production stage).
- Abnormal amounts of wasted materials, labour and other production costs.
- Carriage outwards i.e. the cost of delivering goods to the customer.

1.4.3 Measuring inventory – net realisable value

To ensure that the value of inventory is not overstated, where it has fallen below its cost, inventory should instead be valued at net realisable value (NRV).

NRV comprises:

- Actual / estimated proceeds from sale.
- Less: Estimated costs to completion.
- Less: Estimated costs incurred in marketing / selling.

The principal situations in which NRV is likely to be less than cost are as follows:

- An increase in cost of producing goods.
- Fall in selling price / inability to sell product.
- New competitor in the market.
- Strategic decision to sell products at a loss.
- Physical deterioration of the inventory.
- Obsolescence of inventory.

1.4.4 Cost formulae

The normal basis for valuing inventory is its historical cost but it is sometimes very difficult to derive the historical cost of inventory as a business continually purchases different consignments of the same goods. As consignments are received, the goods are all stored in the same place. When issuing goods, the storekeeper may simply pull out the nearest item, which may not be the oldest in the store. It is therefore typical to have in the same warehouse goods from different consignments. This then makes it very difficult to accurately assess how much each item cost.

The following methods are permitted under IAS 2 and IPSAS 12 for valuing inventory.

- Average weighted cost (AVCO): Inventories are valued at the weighted average price at which items have been purchased during the period.
- First in first out (FIFO): Assumes that the oldest delivery will be issued first.

An entity should use the same cost formula for all inventories having similar nature and use to the entity. For inventories with different nature or use (for Example, certain commodities used in one business segment and the same type of commodities used in another business segment), different cost formulas may be justified.

1.4.5 Inventory Disclosures

IAS 2 requires the following information to be disclosed about inventory:

- Accounting policy for inventories including valuation methods used
- Carrying amount by category of inventory, generally classified as merchandise, supplies, materials, work in progress or finished goods, as appropriate for the entity
- Carrying amount of any inventories carried at fair value less costs to sell
- Amount of any write-down of inventories recognised as an expense in the period
- Amount of any reversal of a write-down to NRV and the circumstances that led to such reversal
- Carrying amount of inventories pledged as security for liabilities
- Cost of inventories recognised as expense (cost of goods sold)

IFRS 18 permits entities to classify Statement of Profit or Loss expenses by nature (materials, labour, and so on) rather than by function (cost of goods sold, selling expense, and so on). IAS 2 therefore offers an alternative to disclosing by function and allows entities to disclose operating costs recognised during the period by nature of the cost (raw materials and consumables, labour costs, other operating costs).

D.2 Financial Instruments

2.1 Introduction

You learned in Financial Reporting that there are three IFRS standards which address accounting for financial instruments:

- IFRS 7 *Financial instruments: Disclosures*
- IFRS 9 *Financial instruments (replacing IAS 39)*
- IAS 32 *Financial instruments: Presentation*

The financial instruments standards cover what are unquestionably among the most complex accounting requirements anywhere in the IFRS and IPSAS Accounting standards. But this complexity is a reflection of the instruments themselves, and the instruments vary from the completely straightforward to the extremely complex. For Example, the financial instrument standards include accounts payable and receivable – these are very simple to account for. They also include Collateralised Debt Obligations (CDOs), structured instruments which securitise underlying financial assets into tranches with varying levels of risk, that were largely responsible for the 2007/08 global financial crisis – these are definitely not simple to account for.

These standards attempt to address the risks associated with the instruments companies use for investment or financing purposes, and this means that the standards need to develop accounting and disclosure rules for every significant innovation dreamt up by investment banks. While accountants who do not work in financial institutions may never encounter a CDO, they need to be familiar with financial instrument accounting because they will inevitably be exposed to payables, receivables and loans. Furthermore, because standards take some time to evolve, accountants need to be alert for the complexities underlying other instruments that may be sold into the market and for which specific requirements have not yet been formalised.

Public sector entities often have rules that limit the complexity or risk that they are allowed to expose themselves to, since their purpose is not to generate profit but deliver services. This type of limit is not universal however, and the IPSAS financial instrument standards are therefore very similar to their IFRS equivalents. The relevant IPSAS are:

- IPSAS 28 *Financial Instruments*: *Presentation*
- IPSAS 30 *Financial instruments*: *Disclosures* and
- IPSAS 41 *Financial Instruments*

This section will follow the requirements of the private sector standards throughout, and close with a comparison of the requirements in IFRS and IPSAS related accounting standards.

A financial instrument is defined in IAS 32 ***Financial Instruments*: *Presentation*** as "Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity." IAS 32 defines its objective as follows:

"The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities."

It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

You were provided with the following table of additional definitions in Financial Reporting:

Definitions and Examples	
Financial asset	Any of the following are classified as financial assets in IAS 32: (a) Cash (b) An equity instrument of another entity (i.e. shares owned in another company, whether a short-term investment in a few shares or a long-term holding in a subsidiary) (c) A contractual right to receive cash or another financial asset from another entity. Trade receivables qualify as financial assets, along with loans made, as both mean that the holder is entitled to receive cash payments from another party. Financial assets do not include physical assets such as inventory.
Financial liability	Any liability that is a contractual obligation to deliver cash or another financial asset to another entity. This definition includes loans, overdrafts, debentures (loan stocks), leases and redeemable preference shares as they all result in a company having a liability to deliver cash in interest and principal payments. Despite the fact that they tend to be short term and non-interest bearing, trade payables are also a financial liability as they result in a contractual obligation to deliver cash (i.e. pay a supplier's invoice).

Definitions and Examples	
Equity instrument	Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Ordinary shares are the main equity instrument in this category.

Assets and liabilities arising out of non-contractual arrangements do not meet the definition of a financial asset or a financial liability. For Example, a provision would not generally be a financial instrument. Physical assets such as property plant and equipment, leased assets, inventories, and intangible assets such as patents and trademarks, are not financial assets. Prepaid assets are not financial assets because they are future economic benefits in that goods or services that have been paid for will be received in the future.

Financial instruments, in other words, only arise from contracts. Contracts involve willing parties entering into an arrangement where the terms create rights and obligations for both parties to the contract that are enforceable in law. If the contract is not completed, in other words, the party that did not receive the goods/ services according to the contract can take legal action and sue the party that did not deliver.

It is important to note that not all instruments called "shares" are necessarily equity instruments, as this depends on the instrument only providing for a residual interest. For Example, and as discussed in Financial Reporting, redeemable preference shares provide the holder with cashflows which include both an interest and principal element, and this makes them financial liabilities to the issuer, and not equity instruments. We will look at this in more detail when we discuss financial liabilities.

2.2 Classification of Financial Assets

IFRS 9 classifies financial assets into one of three types, based on the characteristics of the asset and management's intentions in terms of holding that asset. Companies can carry financial assets for different reasons and these reasons impact on the way that an asset will be recognised and valued. For Example, a pension fund is likely to primarily invest in low-risk assets which generate a reliable cash flow, as pension funds have more or less predictable cash requirements and will want to avoid losing funds which belong to their members. Investment banks, on the other hand, may hold high risk assets for short periods in order to generate profits by buying low and selling high, and the associated cash flows which the asset might generate would be of secondary importance. In the case of the pension fund, day to day volatility in the value of the asset does not necessarily matter, the fund will not sell an asset simply because its value has increased, if the underlying cashflows it generates are more important than its sale value. The investment bank, conversely, will be holding the asset precisely because they want to realise that gain in value. These investment decisions drive the accounting requirements in all these standards.

IFRS 9 divides all financial assets into two classifications: those measured at amortised cost and those measured at fair value.

Assets measured at amortised cost are those which are held by management for the collection of contractual cash flows, including accounts receivable and payable, and most loans. The value of the asset on recognition will be the net discounted value of the contractual cash flows expected over its term, and this will be written down over the term as those cash flows are collected (we will discuss how the discounting works, below). The

pension fund noted above is likely to hold many financial assets which fall under this category.

2.2.1 Financial Assets at Amortised Cost

To classify as amortised cost, the financial asset must meet the following conditions:

- Business model test - The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows ('hold to collect,' see below).
- Cash flow characteristic test - The contractual terms of the financial asset give rise on specified dates to cash flows that are **solely** payments of principal and interest on the principal amount outstanding.

The business model test is determined at a level that reflects how groups of financial assets are managed (rather than on an instrument-by-instrument basis). IFRS 9 recognises three different types of business model: 'hold to collect', 'hold to collect and sell' and 'other'. Assets which are not held to collect and where the cash flows do not solely comprise principal and interest are measured at fair value.

Before we go on to look at fair value, we should consider in more depth at the specific method used when valuing an asset at amortised cost.

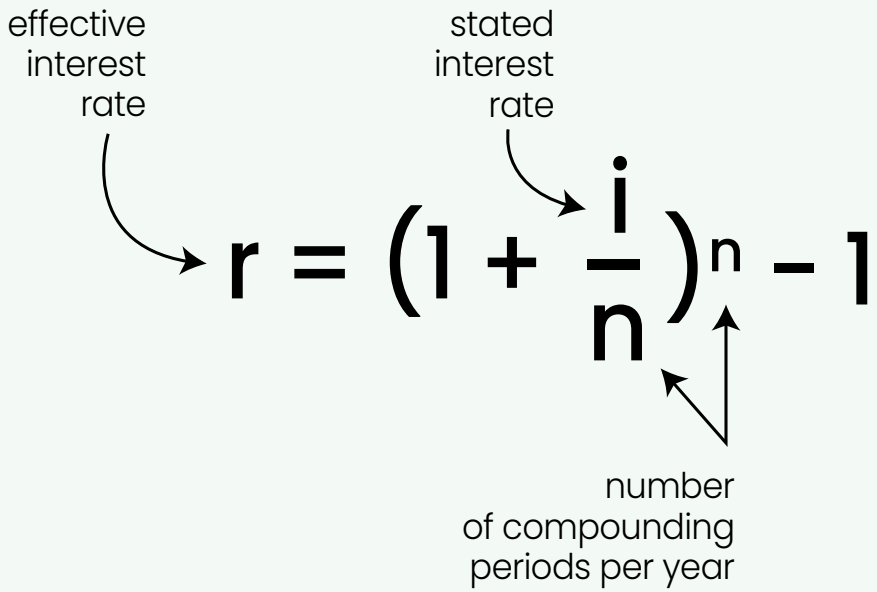
The amount to be initially recognised is the initial cost of the instrument:

- Minus principal repayments.
- Plus, or minus the cumulative amortisation of any difference between initial amount and maturity amount, using the effective interest method.
- Minus any reduction for impairment or valuation allowance.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest revenue or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument (or, when appropriate, a shorter period) to the net carrying amount of the financial asset or financial liability. When calculating the Effective Interest Rate (EIR), an entity estimates cash flows considering all the contractual terms of the financial instrument (e.g., prepayment, call and similar options) but does not consider future credit losses.

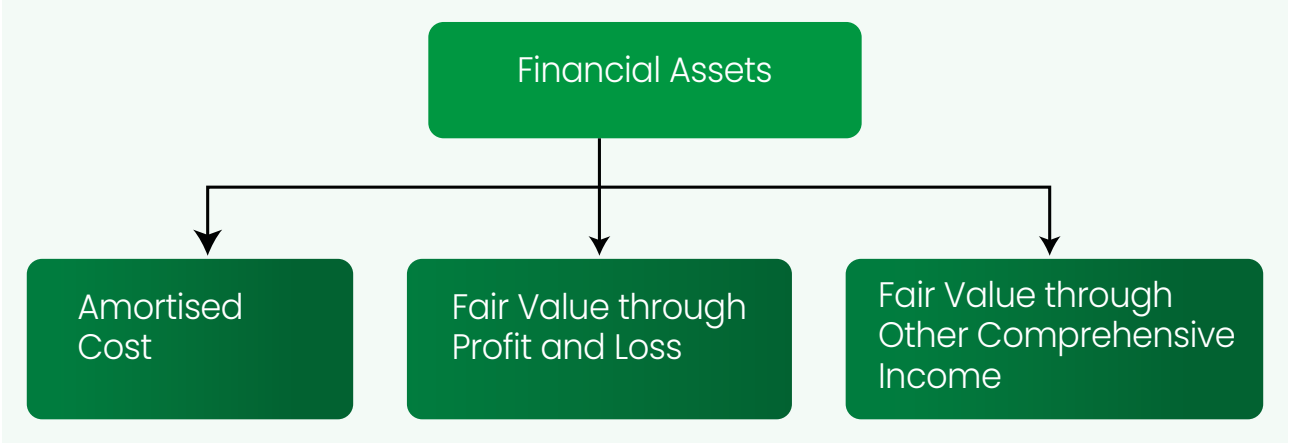
The calculation of the effective interest rate (EIR) includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts. The formula to calculate the EIR is:



2.2.2 Financial Assets at Fair Value

Assets measured at fair value are subdivided between those for which gains and losses are recognised in profit or loss (referred to as fair value through profit or loss, FVTPL); and those whose gains and losses are recognised in other comprehensive income (fair value through other comprehensive income, FVTOCI).

The three main classes of asset are shown below:



You will recall that Other Comprehensive Income is used to record revenues, expenses, gains, and losses that have yet to be realised and are therefore excluded from net income on the Statement of Profit or Loss. This should provide a clue as to how the classification is applied to the investment bank Example noted above. Because losses in value are very important in this situation the asset should be recognised at fair value through profit and loss (FVTPL). Where a company has a mixed management model, in other words it expects to hold assets for cashflows but also regularly sells assets, then it would use FVTOCI.

FVTOCI is the default classification if the financial asset does not meet the requirements of the other two classes. This category can be used for equity instruments when they are

not held for trading, as well as for debt instruments (like bonds) that meet the contractual cash flow test and where the entity intends to 'hold to collect and sell' the financial asset.

Equity investments and derivatives should always be measured at fair value and the general classification category is FVTPL. However, IFRS 9 permits entities to irrevocably elect to classify certain equity investments that are not held for trading as FVTOCI.

The classification of a financial asset is made at the time it is initially recognised, namely when the entity becomes a party to the contractual provisions of the instrument. There are however circumstances where assets may need to be subsequently reclassified, but the standard expects such changes to be very infrequent.

Financial Reporting included the table below as a helpful summary:

Classification	Amortised cost	Fair value through profit or loss	Fair value through other comprehensive income
Reason for classification	**Debt instrument** meets business test and cash flow test – *"held to collect"*	Applies to both "**Debt instrument**" and "**Equity instrument**" held for trading	(i) **Equity Instrument** that is **not** held for trading. (ii) **Debt Instrument** that meets the amortised cost criteria but is held for sale - "*held to collect and sell*"
Initial measurement	Cost plus transaction fees	Cost	Cost plus transaction fees
Subsequent measurement	Amortised cost	Fair value	Fair value

Transaction costs are defined as incremental costs directly attributable to the acquisition, issue or disposal of a financial asset or liability. An incremental cost is one that wouldn't have been incurred if the financial instrument had not been acquired, issued or disposed of. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers, dealers, regulatory agencies and security exchanges, and any applicable transfer taxes and duties. Transaction costs do not encompass debt premiums or discounts, financing costs or internal administrative or holding costs.

Under FVTPL, transaction costs are expensed immediately rather than being included in the value of the instrument, in order to reflect the holding model. Since the instrument is being effectively held for sale, it would not be appropriate to capitalise the transaction costs.

For financial assets not classified as FVTPL, transaction costs are added to the fair value at initial recognition *(DR Financial asset with the transaction costs – hence having a "plus effect" on the financial asset)*. With financial liabilities, transaction costs are deducted from the fair value at initial recognition *(DR Financial liability with the transaction costs – hence having a "minus effect" on the financial liability)*.

For equity investments measured at FVTOCI, transaction costs are recognised in other comprehensive income as part of a change in fair value at the next re-measurement.

2.3 Classification of Financial Liabilities

Almost all financial liabilities are measured at amortised cost, meaning that a finance cost is reported in profit or loss based on the effective rate of interest. Financial liabilities held for trading, including derivative liabilities, are measured at FVTPL.

As with financial assets, a company can designate, at initial recognition, a financial liability to be measured at FVTPL if it would eliminate or significantly reduce an 'accounting mismatch'. Accounting mis-matches can arise when an instrument gives rise to assets and liabilities that are measured at different bases. For Example, where a company borrows money to purchase investment property, the asset will be carried at fair value but the corresponding liability would by default be measured at amortised cost. Electing to select FVTPL as the valuation base for the liability will align the measurement basis, ensuring both elements are measured using current interest rates.

Using FVTPL to measure liabilities can result in the changes in the company's credit worthiness impacting on the value of those liabilities, since the credit worthiness of a debt issuer will directly impact on the subsequent fair value of their debt. So, if a company issues a debt instrument and then suffers a drop in its credit worthiness, the value of the liability will fall, resulting in a fair value gain for the company; conversely, a gain in credit worthiness may lead to a fair value loss because the company would be theoretically able to issue the debt at a lower coupon rate or other incentive at sale.

IFRS 9 states that companies should classify all financial liabilities as subsequently measured at amortised cost, except for:

- Financial guarantee contracts,
- Commitments to provide a loan at below-market interest rate,
- Contingent consideration recognised by an acquirer in a business combination; and
- Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition.

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs, because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. To the issuer, a financial liability arising from a financial guarantee contract is classified as a financial liability carried at FVTPL.

A contingent consideration is a payment in an acquisition context that will be made by the acquirer at a future date if certain events occur, such as a specific level of sales or share price valuation. Contingent considerations are common in acquisitions and they will represent a liability (or asset to the seller) whose valuation needs to reflect the risks associated with the events occurring. To the issuer, a financial liability arising from a contingent liability is classified as a financial liability carried at FVTPL

2.4 Equity Instruments

All equity investments falling in the scope of IFRS 9 are to be measured at fair value in the statement of financial position, with fair value changes recognised in profit or loss, except for those equity investments for which the entity has elected to present fair value

changes in 'other comprehensive income'.

2.5 Subsequent Measurement of Financial Instruments

Financial Assets are subsequently measured according to their initial classification, using:

- Amortised Cost
- FVTPL
- FVTOCI

Financial assets measured at amortised cost or FVTOCI (only debt instruments) are reviewed for impairment at each reporting date.

Financial liabilities are subsequently measured at amortised cost, with the four exceptions noted above.

2.5.1 Gains and losses on a financial asset or financial liability

Where financial instruments are measured at fair value, gains and losses are recognised entirely in profit or loss (FVTPL) unless:

(a) The instrument is part of a hedging relationship.

(b) The instrument is an investment in an equity instrument and the entity has permanently elected to present gains and losses on that investment in other comprehensive income.

(c) It is a financial liability designated as at FVTPL and the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income.

(d) It is a financial asset measured at FVTOCI and the entity is required to recognise changes in fair value in other comprehensive income (e.g., a debt instrument where the entity's business model is to both "collect" contractual cashflows and "sell" the financial asset).

Essentially, this is saying that any instruments which are not held for trading may need to have changes in their value recorded in Other Comprehensive Income rather than Profit or Loss but this will depend on the specific decisions made when classifying the instrument.

2.5.2 Impairment of financial assets

Except for investments in equity instruments, financial assets classified as amortised cost or FVTOCI must be tested for impairment at the end of each reporting period. Impairments of financial assets are recognised as Expected Credit Losses (ECLs), which represent a probability-weighted estimate of credit losses anticipated on the instrument. A credit loss is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive, discounted at the original effective interest rate.

ECLs should be measured in a way that reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, the time value of money and reasonable and supportable information. Because ECL consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full at a later date than when contractually due.

IFRS 9 distinguishes between '12-month expected credit losses' and 'lifetime expected credit losses'. The decision as to whether the loss allowance is based upon 12-month expected credit losses or lifetime expected credit losses depends on whether there has been a significant increase in credit risk since initial recognition. An increase in credit risk is reflected by a change in the risk of a default occurring over the expected life of the financial asset. When making the assessment the company must consider reasonable and supportable information, that is available without undue cost or effort that is indicative of significant increases in credit risk since initial recognition. If the financial instrument has low credit risk at the reporting date, then the company can assume that the credit risk has not increased significantly since initial recognition. Low credit risk is based on a company's internal credit risk ratings, or other acceptable methods (and not necessarily dependent on a rating agency such as Moody's or Standard and Poor issuing a formal rating).

If a financial asset's credit risk has not increased significantly since initial recognition, a company calculates 12-month expected credit losses. This means that expected credit losses are calculated based on default events that are possible within 12 months from the reporting date. Where the credit risk has increased significantly since initial recognition, a company calculates lifetime expected credit losses. This means that expected credit losses are calculated based on all possible default events over the expected life of the financial instrument.

A company assesses at each reporting date whether the credit risk associated with a financial asset has increased significantly since initial recognition.

IFRS 9 provides a simplified approach which can be used to assess the degree of impairment of more straightforward financial assets such as trade receivables or contract assets that do not contain a significant financing component. Under this approach the loss allowance should be measured at initial recognition and throughout the life of the receivable at an amount equal to lifetime ECL.

Where the simplified approach involves the calculation of historical loss rates, the general approach is complex. It usually involves, among other things, calculation of the probability of default, considering whether there have been significant increases in credit risk, and forward-looking macro-economic information.

The general approach is used by financial institutions and helps reflect the features of more complex financial arrangements such as collateral and long maturity terms when valuing financial assets. There are three functions that need to be considered:

Exposure at default (EAD). This is the amount of principal to which the calculated probability of default rate and the loss given default rate is applied. A repayment rate is calculated based on an historic analysis of repayments in the period to default. EAD = The principal amount outstanding x (1- the calculated repayment rate in the period to default). **Probability of default (PD).** This is an estimate of the likelihood of default over a given period. PD is determined based on the historical loss experience of an entity. This historic PD is then adjusted by a factor, determined by reviewing the historic relationship between key economic parameters such as GDP and unemployment and PD. Forward-looking macro-economic information relating to, say, future GDP and/or unemployment is then considered and the calculated historical PD is adjusted.

Loss given default (LGD). This is an adjustment to the ECL calculation for post-default recoveries. These can be in the form of cash repayments, proceeds from the realisation of security or sale of the debt to a third party. The LGD is based on an analysis of historical post-default recoveries. LGD = 1- the post-default recovery rate.

The calculation process

Once the three functions are determined, the ECL is calculated as EAD x PD x LGD. The calculation can be either for 12 months or based on the lifetime of the financial asset. This depends on whether there has been a significant increase in credit risk since the date of initial recognition. The credit loss that is calculated on a 12-month basis involves analysis of historical credit losses over 12 months.

Credit loss calculated over the lifetime of the financial asset (future losses) is derived from historical losses over the life of the asset (past losses). The PD calculated on a lifetime basis will be higher than the PD calculated over 12 months because a borrower, for Example, is more likely to default over the next five years than over the next year. As such, the lifetime ECL will be higher than the 12-month ECL.

It should be clear that this is an extremely complex process, but it is helpful for financial institutions with sophisticated risk management arrangements, as it allows them to reduce the degree of expected loss they have to recognise, based on the more sophisticated analysis undertaken.

If an actual default event occurs and the financial asset becomes credit-impaired, lifetime expected credit losses are calculated as the difference between the asset's gross carrying amount and the present value of the expected future cash flows.

A three-stage model is used to manage impairments under IFRS 9, with each stage reflecting a different level of anticipated credit risk associated with an instrument:

	Stage 1	**Stage 2**	**Stage 3**
Trigger	Initial Recognition	Significant increase in credit risk	Credit impaired
ECL	12 Months ECL	Lifetime ECL	Lifetime ECL
Expected Interest Rate (EIR)	EIR on gross carrying amount (excludes ECL). *EIR = Effective interest rate x Gross loan asset*	EIR on gross carrying amount (excludes ECL). *EIR = Effective interest rate x Gross loan asset*	EIR on amortised cost (includes ECL). *EIR = Effective interest rate x Net loan asset* *(where net loan asset = Gross loan asset minus impairment loss)*

2.6 Derivative financial instruments

Derivative contracts can be used by companies to manage risk. For Example, a company that manufactures bread may reduce its exposure to changes in the price of wheat by entering into futures contracts to buy wheat for a fixed price in six months' time. These contracts will be settled net in cash: if wheat prices rise, the company will make a gain on the contracts; if wheat prices fall, the company will make a loss. This contract will be attractive if the company expects wheat prices to rise, perhaps it anticipates a poor harvest, but the counterparty will need to be willing to take on the downside of that risk.

According to IFRS 9, a derivative is a contract that:

1. will be settled at a future date
2. requires no (or a low) initial investment, and
3. changes value in response to movements in an underlying item (such as commodity prices or interest rates).

The key feature of derivative contracts is the third characteristic above. The contract is called a derivative because its value derives from, and fluctuates in response to changes in, an 'underlying' variable. This variable could be a specific interest rate, the price of a financial instrument or commodity, a foreign exchange rate, an index of prices or rates, a credit rating or credit index, or another element. If a non-financial variable is involved, it should not be specific to a party in the contract. Options, calls, swaps and forward contracts can all include derivative instruments.

IFRS 9 also introduces the notion of an embedded derivative. This is a component of a combined or hybrid instrument that includes a non-derivative host contract. This guidance is necessary to ensure that companies do not attempt to evade the disclosure requirements in respect of derivatives by embedding them within other contracts. Under certain conditions, embedded derivatives must be accounted for separately, as if they were distinct financial instruments.

A derivative's value often changes due to it having an underlying notional amount, such as a specific currency amount or a set number of shares. For instance, a fair value of a forward contract, which is to convert USD 10 million to EUR at a fixed exchange rate in 6 months, will change in line with USD/EUR market exchange rates proportionate to the USD 10 million notional amount. However, a derivative can also require a fixed payment or a payment amount that can vary (but not in direct proportion to a change in the underlying) due to some unrelated future event. For Example, a contract could stipulate a fixed payment of USD 100,000 if the six-month LIBOR increases by 100 basis points. Such a contract is still a derivative, despite not specifying a notional amount.

2.6.1 Recognition

All derivatives are measured at fair value and re-measured to fair value at each subsequent reporting date. Changes in fair value are recognised in profit or loss unless the entity has elected to apply hedge accounting by designating the derivative as a hedging instrument in an eligible hedging relationship. Hedging is one of the main applications for derivatives and we will turn to the subject below.

2.7 Hedge accounting

As noted above, derivatives are used by companies to manage risk. In the financial statements, they are re-measured to fair value at each reporting date, with the gain or loss recognised in profit or loss. However, the item that was generating the risk may not be recognised in the financial statements (such as a future purchase of wheat), or it may be accounted for in a different way (such as inventories of wheat, which are measured at the lower of cost and net realisable value). This gives rise to an accounting mismatch and causes volatility in profit or loss that can make the company look like a riskier investment to its shareholders, even where the company has taken proactive steps to manage its risk by using a derivative. This outcome can be reduced or eliminated if the company chooses to apply hedge accounting.

Hedge accounting is designating one or more instruments as a hedge against a specific type of risk, so that any change in fair value caused by that risk crystallising is offset by the change in fair value or cash flows of the hedged item.

The two components of a hedging relationship are therefore the:

- **Hedged item:** this is an item that carries certain risk. It could be a recognized asset or liability, an unrecognized firm commitment, a forecast transaction (anticipated sale or purchase) or a net investment in a foreign operation.
- **Hedging instrument**: a derivative (or some other non-derivative financial asset or a non-derivative financial liability) whose fair value changes are expected to offset the fair value changes of a hedged item.

Simply said, if there is a loss on the hedged item, there will be a gain on the hedging instrument to offset that loss. And the opposite is equally true: if there is a gain on the hedged item, there will be a loss on the hedging instrument. Hedging helps eliminate uncertainty.

Hedge accounting is thus a method which IFRS provides as an option, for recognising and measuring instruments used in the following types of hedging relationships:

- **Fair value hedge:** a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, that is attributable to a particular risk and could affect profit or loss.
- **Cash flow hedge:** a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction, and could affect profit or loss.

Both types of hedges involve a specific risk to a specific asset or liability, whether that effects potential future cash flows or fair values. A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

- The hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- At the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
- The hedging relationship meets all the hedge effectiveness requirements.

The "hedge effectiveness requirements" must be assessed at each reporting date, which involves confirming that:

- There is an economic relationship between the hedged item and the hedging instrument.
- The effect of credit risk does not dominate the value changes that result from that economic relationship.
- The hedge ratio of the hedging relationship is the same as that actually used in the economic hedge.

A hedge ratio is a financial metric that measures the level of risk exposure covered by a hedge. It is calculated by comparing the value of a position protected by a hedge to the size of the entire position. A hedge ratio close to 1 means the position is "fully hedged", while a hedge ratio close to 0 means the position is "unhedged".

The purpose of this assessment is to ensure that the components of the hedge remain in balance and that the hedging instrument continues to be effective. If the risks associated with the hedge have increased then it may be necessary to extend or take out a new hedging contract to reflect that increased risk.

2.7.1 Accounting for Hedges

When accounting for hedges at the reporting date, the first step is to split the fair value gain or loss on the hedging instrument between the portion that was effective in offsetting a corresponding change in the hedged item, and the portion that was ineffective. The treatment of the effective portion varies depending on whether it relates to a fair value hedge or a cash flow hedge, however the ineffective portion is charged to profit or loss under both approaches (unless the hedged item is equity measured at FVTOCI).

Fair value hedge accounting

If the fair value hedge meets the qualifying criteria, the hedging instrument is re-measured at fair value. The fair value gain or loss of the hedging instrument is recognised in profit or loss.

The carrying amount of the hedged item is adjusted for the gain or loss attributable to the hedged risk only and is also recognised in profit or loss. Thus, all gains and losses attributed to the hedged risk are recognised in the statement of profit or loss, with the result that there is no net profit and loss effect, other than any hedge ineffectiveness.

Note that if the hedged item is an equity instrument designated to be measured at FVOCI, then the gains and losses on the hedged item and hedging instrument are both reported in other comprehensive income rather than in profit or loss.

Cash flow hedge accounting

If the cash flow hedge meets the qualifying criteria, the hedging instrument is re-measured at fair value. Gains or losses on the effective portion of the hedging instrument are initially recognised in OCI. These amounts will be transferred to a 'cashflow hedging reserve' as a separate component of equity. The ineffective portion of the gain or loss on the hedging instrument is recognised in the statement of profit or loss.

In the subsequent period, if the cash flows relating to the hedged item are reported in profit and loss, then the cumulative amounts in OCI related to the changes in value of the hedging instrument are reclassified ('recycled') to the statement of profit or loss.

2.8 Financial Instruments: IAS 32 – Presentation

The objective of this standard is to establish principles for presenting financial instruments as liabilities or net assets/equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities, and equity instruments; the classification of related interest, dividends or similar distributions, losses, and gains; and the circumstances in which financial assets and financial liabilities should be offset.

IAS 32 requires that financial instruments should be classified based on their substance rather than their legal form. The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer to deliver cash or another financial asset to the other party. If such an obligation exists, that instrument

meets the definition of financial liability. Where an instrument meets the definition of financial liability, any interest dividends, or similar distributions, along with any gains and losses relating to the instrument, will be treated as expense or revenue as appropriate.

2.8.1 Compound financial instruments

The situation becomes more complex with financial instruments which combine elements of equity instruments and financial liabilities. These are known as compound financial instruments. Compound financial instruments are a mixture of debt and equity. An Example is convertible loan stock issued by a company which gives the holder the right to convert the stock into shares in the company at a future date. In this case, there is both a liability element and an equity element. The normal method of valuing the components of such an instrument is to calculate the present value of the liability component on the initial recognition of the compound financial instrument in the financial statements of the issuer. The equity component is then the balance of the total value.

When considering the treatment of compound financial instruments, it is important to distinguish between the issuer of the instrument and the holders, as the accounting treatment is quite different.

The issuer must perform the following steps on initial recognition:

- **Step 1: Identify the various components of the compound financial instrument:** the issuer must clearly identify what the liability element is and what the equity element is.
- **Step 2: Determine the fair value of the compound financial instrument as a whole:** under market conditions the fair value of the instrument as a whole equals the cash received in return for the instrument.
- **Step 3: Determine the fair value of the liability component:** the fair value of the liability component can be determined at fair value of a similar liability that does not have any associated equity conversion feature. For Example, the fair value of the liability component of a convertible bond equals to fair value of the bond with the same parameters (maturity, coupon rate, etc.) but without the option to convert into issuer's shares.
- **Step 4: Determine the fair value of the equity component:** the equity component is determined simply as the fair value of the compound financial instrument as a whole (step 2) less the fair value of the liability component (step 3).

If the issuer incurs certain costs associated with the issue of compound financial instruments, these should be allocated to the liability and equity components proportionally.

Subsequently, after initial recognition, the equity component is not remeasured and remains unchanged until the final settlement.

The liability component is accounted for in line with IFRS 9, either by application of effective interest rate method or at fair value through profit or loss, depending on the classification of the liability.

The holder recognises two assets:

- A derivative financial asset which corresponds to the equity component of the instrument.
- A receivable towards issuer which is the loan provided to the issuer by acquiring the compound instrument.

In this case, the derivative financial asset is measured first at the fair value of the option, and the fair value of the receivable is calculated as the residual. IFRS 9 deals with the classification and measurement of financial assets that are compound financial instruments from the holder's perspective, and not IAS 32.

2.8.2 Netting off

IAS 32 permits the netting off a financial asset and a financial liability when, and only when, the entity has a legally enforceable right to set off the amounts and intends either to settle on a net basis or simultaneously. In other words, netting off is only really possible where the asset and liability are contractually linked and where management intend to settle the liability and dispose of the asset at the same time.

2.9 IFRS 7 Financial Instruments: Disclosures

Whereas IAS 32 defines principles that should be applied when developing accounting policies for financial instruments, IFRS 7 sets out specific disclosure requirements, based on the decisions made by management in terms of the classification and management of those instruments. IFRS 7 mandates that entities disclose specific information in their financial statements to assist users in understanding:

- The significance of financial instruments to the entity's financial position and performance
- The nature and extent of risks from financial instruments during, and at the close of, the reporting period
- How the entity manages these risks

The level of detail in these disclosures should reflect the entity's usage of financial instruments and its exposure to associated risks. Entities engaged extensively with financial instruments and risks must provide detailed disclosures in their financial statements. Conversely, entities with minimal engagement in financial instruments and risks can provide less detailed disclosures.

The disclosure requirements are very detailed and require entities to set out the classifications used when recognising equity instruments and financial assets and liabilities, i.e. amortised cost, FVTPL or FVTOCI. The disclosures are grouped based on which component of the financial statements they relate to, whether the statement of financial position, statement of financial performance, or notes (including accounting policies). They include:

- Reclassifications
- Offsetting financial assets and liabilities
- Collateral
- Credit loss allowance for assets measured at FVTOCI

The standard requires that the basis on which fair value was determined for more complex financial instruments is described using what it terms a "fair value hierarchy," which is derived from IFRS 13 Fair Value Measurement. The fair value hierarchy is a way of grouping different types of inputs that can be used to support a valuation based on the reliability of the inputs and is applied based on the lowest level of input significant to the overall fair value:

- Level 1 – quoted prices for similar instruments
- Level 2 – directly observable market inputs other than Level 1 inputs
- Level 3 – inputs not based on observable market data

So, a US treasury bond would clearly be a level 1 instrument, while a derivative that was tailored to a specific company's needs should be classed as level 2 due to the absence of an active market for similar instruments. Stock markets should be able to provide level 1 valuation inputs but only if that type of instrument is being actively and continually traded. The application of the hierarchy is intended to give users of the financial statements a more detailed understanding of the reliability of valuation for financial instruments. The main fair value disclosures are:

- Description of how fair value was determined
- The level of inputs used in determining fair value
- Reconciliations of movements between levels of fair value measurement hierarchy
- Additional disclosures for financial instruments whose fair value is determined using level 3 inputs including impacts on profit and loss, other comprehensive income and sensitivity analysis
- Information available if fair value cannot be reliably measured including why fair value cannot be measured reliably.

Note that disclosure of fair values is not required when the carrying amount is a reasonable approximation of fair value, such as short-term trade receivables and payables, or for instruments whose fair value cannot be measured reliably.

Alongside this extensive analysis, IFRS 7 also requires entities to disclose information that assists users in evaluating the nature and extent of risks from financial instruments at the end of the reporting period. This include both qualitative and quantitative disclosures on:

- Credit risk
- Liquidity risk
- Market risk

Credit risk relates to financial assets and is the risk that an entity will suffer a financial loss due to counterparty failing to pay its obligations.

The following disclosures are required for entities that have trade receivables or provide loans which are exposed to credit risk:

- Credit risk management practices (e.g. how do customers qualify to buy on credit)
- Information about amounts arising from expected credit losses
- Credit risk exposure (e.g. what is the historic default rate of receivables, based on their age)
- Collateral and other credit enhancements relating to assets

Liquidity risk relates to financial liabilities rather than assets. It is the risk that the entity will not meet its obligations from financial liabilities which need to be settled with cash or another financial asset at a specified date.

Entities should disclose:

- Maturity analysis of financial liabilities with remaining contractual maturities

(separately for non-derivative and derivative)

- How the entity manages the liquidity risk (e.g. treasury management or hedging policies)

Market risk is the risk that either the fair value or future cash flows from financial assets or financial liabilities will fluctuate due to changes in market prices.

Market risk has a several components, based on what gives rise to the potential change in future cash flows or fair value:

- Currency risk: the risk that foreign exchange rate changes cause the fluctuations in cash flows or fair values (receivables due in a different currency can both gain and lose value)
- Interest rate risk: fluctuations are caused by the changes in interest rates (this may be significant for variable rate loans)
- Other price risk: fluctuations are caused by the changes in other market prices, such as commodity prices, equity prices, etc.

The disclosures for market risk require the entity to produce sensitivity analysis forecasting, for Example, what a change in interest rates would mean in terms of the value of the related instrument, and its future cash flows.

D.3 Employee Rewards

3.1 Introduction

Contracts of employment give rise to obligations on the part of the employer to pay certain amounts to employees for the performance of their duties. Some of those obligations, like salaries and wages, are expenses which might give rise to liabilities simply because they had not been paid at the reporting date. Other forms of benefit, however, are more complicated to account for, particularly certain post-employment benefits which cannot be covered by the standard accounting treatment for expenses and accounts payable, primarily because of the complexity of valuing the liability. The majority of the content of the employee benefit standard (IAS 19 ***Employee Benefits***) thus explains how entities should account for what is referred to as "defined benefit" pension plans. In addition, IAS 19 provides guidance on accounting for other common methods of remunerating employees, such as salaries, paid holidays and sick pay, as well as more unusual ones such as profit-sharing agreements.

In this section we will look first at the more straightforward forms of employee benefit, which are referred to as "short term," before we turn to the more complex areas. Both IAS and IPSAS have dedicated employee benefit standards (IAS 19 ***Employee Benefits*** and IPSAS 39 ***Employee Benefits***) and we will follow IAS 19 for most of this analysis, because they are very similar. The section will close by looking at the differences between the IPSAS 39 and IAS 19.

3.2 Objective and Scope

The objective of IAS 19 is to prescribe the accounting and disclosure for employee benefits. The standard requires an entity to recognise:

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

(b) an expense when the entity consumes the economic benefit arising from service.

IAS 19 does not cover share-based employee payments, as these have a specific standard: IFRS 2 ***Share Based Payment.*** IAS 19 is not applied by employee benefit plans / fund managers themselves, as they have their own reporting requirements set out in IAS 26 ***Accounting and Reporting by Retirement Benefit Plans***. In addition, where employee expenses are incurred in the construction of a significant asset, or in the production of inventory, those expenses will not be accounted for under IAS 19, but included in the costs of the respective assets, under IAS 2 ***Inventories***, or IAS 16 ***Property Plant and Equipment***.

IAS 19 defines the employee benefits which are covered by the standard as follows:

(a) short-term employee benefits, such as the following, if expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services:
    (i) wages, salaries and social security contributions
    (ii) paid annual leave and paid sick leave
    (iii) profit-sharing and bonuses
    (iv) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees

(b) post-employment benefits, such as the following:
    (i) retirement benefits (e.g. pensions and lump sum payments on retirement)
    (ii) other post-employment benefits, such as post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, such as the following:
    (i) long-term paid absences such as long-service leave or sabbatical leave
    (ii) jubilee or other long-service benefits
    (iii) long-term disability benefits

(d) termination benefits.

Short term benefits are termed "short-term" because they should be paid out or used up by the employee within a year of being recognised as liabilities on the Statement of Financial Position. Long term benefits may involve a liability to the employee which accrues over several reporting periods. Post employment benefits represent ongoing liabilities to the entity which will potentially require payment by the entity long after the employee has ceased contributing to the entity's performance.

In terms of application, the standard notes that payments to employee benefits include benefits provided either to employees or to their dependants or beneficiaries and may be settled by payments (or the provision of goods or services) made either directly to the employees, to their spouses, children or other dependants or to others, such as insurance companies.

Employee benefits are recognised in most types of employment relationships, i.e. an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of IAS 19, employees also include directors and other management personnel.

The employee benefits covered by IAS 19 are not always determined solely by agreement between the employer and the employee as they include those which arise:

(a) under formal plans or other formal agreements between an entity and individual employees, groups of employees or their representatives;

(b) under legislative requirements, or through industry arrangements, whereby entities are required to contribute to national, state, industry or other multi-employer plans; or

(c) by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay the employee benefits.

An Example of (c) above, would be a company which has historically provided its employees with a food hamper at Christmas, despite this not being specified in employment contracts. The fact that the hampers had been provided in the past gives rise to a constructive obligation which entitles the company to account for the expense under IAS 19.

3.3 Key Definitions

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

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service. Salaries, wages and annual bonuses are Examples of this type of benefit. **Post-employment benefits** are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. The most common post-employment benefits are pensions.

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits. Examples of these benefits would include medical or life insurance provided to former employees.

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

(a) an entity's decision to terminate an employee's employment before the normal retirement date; or

(b) an employee's decision to accept an offer of benefits in exchange for the termination of employment (this is likely to occur when companies discontinue operations or downsize).

3.4 Short Term Benefits

As noted above, short term benefits cover the most common forms of employee benefit, such as wages (amounts paid in respect of the specific work done during the reporting period) or salaries (a fixed sum paid each month to the employee irrespective of their productivity). In most cases, accounting for short term benefits is quite straightforward, though there may be some complexity involved where employees receive benefits in kind, such as access to a vehicle or housing (specifically where PAYE is remitted by the employer and these benefits give rise to a tax obligation on the part of the employee).

3.4.1 Recognition

IAS 19 requires entities to recognise an obligation to employees who have rendered services to the entity during the reporting period. Recognition will take the form of an expense if the obligation has been settled at the reporting date, and/or a liability for any amount outstanding to the employee.

For Example, most employees are paid in arrears, so they may start a new job on first of September and receive their salaries for that month on the thirtieth of September. No liability in respect of the employee's salary would therefore need to be recognised at month end, with the entire amount paid recognised in expenses. If the employee was also enrolled in a company bonus scheme that is paid out quarterly, and the employee was eligible and met their performance targets for that month, the employer would recognise a liability for the proportion of the bonus that they has earned in that month, which amount would reconcile the total earned (salary and bonus) to the amount actually paid (salary only). If on the other hand, the employee had been given an advance on their salary, that amount would be recognised as a pre-payment, or asset.

One further consideration in terms of the entity's recognition of liabilities is that not all employee related liabilities will be due to the employees themselves. Many employees authorise their employers to make deductions from their salary to pay for personal obligations, such as medical insurance or income tax (commonly referred to as Pay as You Earn). In the event that these amounts have not been remitted to the medical insurance company or tax authority at month end, the reporting entity should recognise a liability for the amounts due to be remitted.

Because short term benefits are expected to be settled by the end of the following reporting period they are not discounted.

Paid Absences

Many companies provide employees with paid leave of absence, a form of benefit which is often mandated by national employment laws. The most common forms of this type of benefit are annual leave and sick leave entitlements. The recognition rules for paid absences depend on whether the benefit is accumulating or non-accumulating.

Accumulating benefits are those that the employee can accrue over more than one reporting period, so that any unused entitlement can be carried forward to the next year. Annual leave is often an accumulating benefit, though many companies enforce limits on the number / amount of days that can be carried forward, or enforce a period beyond which the entitlement will lapse if the benefit is not taken up by the employee. This latter rule is very common because accumulated unused annual leave has to be settled in cash when the employee ceases employment. So, an employee on a three-year contract, for Example, may be entitled to 20 days per year annual leave, but is only allowed to carry forward a maximum of 10 days per year, and at contract end is only allowed to hold (and therefore be paid) a maximum of 20 days unused leave. Accumulating benefits hence give rise to liabilities at the reporting date and the liability will be equal to the total amount of such benefit to which the employee is entitled. A benefit accumulated over multiple reporting period should be discounted.

Non accumulating benefits cannot be accrued by the employee if unused at year end. This is very often the case with sick leave, where the employee may be entitled to a certain number of paid days each year in case, they fall sick, but any unused entitlement will lapse at year end. Employers will not recognise a liability at the reporting date in respect of non-accumulating benefits.

Where sick leave is accumulating, the employer will not necessarily recognise a liability for the total amount of sick leave unused because sick leave will often only be paid if the leave request is supported by a doctor's note. The entitlement is not automatic, in other words. In such cases the employer will estimate the liability based on the amount of sick leave days typically utilised in the past.

Bonuses and Profit-Sharing Schemes

Payments of bonuses and profit sharing is often conditional on the employee remaining in employment for a specific period and hence eligible to receive the benefit. In such situations, the employer will estimate the number of employees who will be eligible at the reporting date when calculating the value of the liability. It should be noted that where such schemes operate over multiple years they should be classed as other long term employee benefits, rather than short term benefits. In such cases the liability may need to be discounted to reflect the time period until expected settlement.

It may not always be easy to estimate the amount of profit that will be generated (or bonus earned), as they can fluctuate based on many external and internal factors (the company might make a loss for the year, for Example). IAS 16 therefore specifies that:

An entity can make a reliable estimate of its legal or constructive obligation under a profit-sharing or bonus plan when, and only when:

(a) the formal terms of the plan contain a formula for determining the amount of the benefit;

(b) the entity determines the amounts to be paid before the financial statements are authorised for issue; or

(c) past practice gives clear evidence of the amount of the entity's constructive obligation. 3.4.2 Disclosure

IAS 16 does not include any specific disclosures about short-term employee benefits. However, other standards may require them, for Example:

- IAS 24 Related Party Disclosures requires disclosures about employee benefits for key management personnel.
- IFRS 18Presentation and Disclosure in Financial Statements requires that the profit and loss statement shows employee benefit expenses as a specific line item.

3.5 Post Employment Benefits

Post employment benefits represent the most complex aspect of employee benefit accounting, and many online articles and discussion on IAS 19 devote themselves entirely to one area of post-employment benefit, namely defined benefit pension schemes, or plans. This is because these plans are or have been very topical and because they are extremely complex, involving the input of actuaries to determine the value of the liability and the discount rates to be applied over very long terms.

3.5.1 Defined Contribution vs Defined Benefit

Defined contribution pensions usually involve both the employer and the employee paying a fixed amount each month into a third-party fund that uses those contributions to pay benefits to the employee following their retirement. Sometimes defined contribution plans are managed by the employer themselves, but in this case the plan assets are ring-

fenced from the company's other assets and cannot be used for any purpose other than servicing the pension plan. As a result of this arrangement, the employer transfers their entire obligation to provide those benefits to the third party or plan, and the accounting treatment is thus very similar to that applied to short term benefits (i.e. operating expenses which may be accrued at the reporting date if deducted but not paid on to the fund).

Under a defined benefits plan, the benefits payable to employees are not based solely on the amount of the contributions paid, but are determined by the terms of the plan. For Example, they are often called "final salary" schemes because the amount paid out to the retired employee will be based on the salary they earned when they ceased to work, adjusted for length of service and conditional upon the employee reaching retirement age. The employer retains the actuarial and investment risks of the plan, which means that they have to manage the expected cash flow obligations that the plan entails, in terms of estimating the expected life spans of retirees and ensuring sufficient assets are available to pay out the benefits for that period.

In practice this means that any underperformance of the investments which results in the plan being unable to meet its obligation will require the employer to inject cash into the defined benefit plan. It should be noted that some plans are actually unfunded, in that the employer has not set aside any specific assets to pay benefits and thus must use its operational resources to meet these obligations. Unfunded plans are usual, but may be encountered in government, particularly governments that use cash-based accounting. Defined benefit plans used to be quite widespread, particularly in developed countries, and even more so in the public sector, where other benefits often compensate for comparatively low salaries. This is because people in the past took a longer-term view that future revenues would be able to fund future pension payments. Some years ago, a more short-term view was generally adopted which required assets to be identified today to pay tomorrow's liabilities, and this inevitably led to such plans being viewed as unaffordable. Hence new employees today, unlike an older generation, will have comparatively fewer opportunities to join a defined benefit plan, wherever they work or live, and their future pension benefits will thus be much more subject to the variabilities of financial markets.

3.5.2 Defined Contribution Plans

As noted above, a defined contribution plan involves the employer paying a regular contribution (usually a percentage of employees' pay) into a separate fund that leaves the employer with no legal or constructive obligation to pay further contributions if the fund does not have sufficient assets to pay employee benefits. The combined contributions are invested by the fund and pensions are then paid to former employees based on the contributions made. Both actuarial and investment risks are transferred from the employer to the employee under a defined contribution plan.

Disclosure

The disclosures required for defined contribution plans by employers are limited to showing in operating expenses the total amount contributed on the employee's behalf by the company (this will exclude any amounts contributed by the employees themselves). A short-term liability may be recognised if amounts have been deducted and/or expensed at the reporting date without being remitted to the fund.

3.5.3 Defined Benefit Plans

Accounting by an entity for defined benefit plans involves the following steps:

1. Determining the fund's deficit or surplus
2. Determining the amount of the net defined benefit liability or asset (the Statement of Financial Position entries)
3. Determining amounts to be recognised in profit or loss
4. Determining the re-measurements of the net defined benefit liability (asset), to be recognised in other comprehensive income

We will explain the terms and the process to be followed in each step, below.

Determining the deficit or surplus

This first step involves:

(a) using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods. This requires an entity to determine how much benefit is attributable to the current and prior periods and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will affect the cost of the benefit.

(b) discounting that benefit in order to determine the **present value** (PV) of the defined benefit obligation and the current service cost.

(c) deducting the **fair value** (FV) of any plan assets from the present value of the defined benefit obligation.

Defined benefit plans need to pay out current obligations owed in respect of retired former employees as well as build up a surplus to pay the future obligations of current employees. The first step is thus to use actuarial techniques to weigh the many complex variables that will determine the value of these obligations. Actuarial techniques are used to analyse the financial costs of risk and uncertainty using mathematics, statistics, and financial theory. These variables include:

- Future rates of pay inflation and pay increases
- Number of employees joining the plan
- Age profile of employees
- Financial assumptions such as discount rates and benefits level
- Wider issues such as mortality rates or changes in the retirement age.

This value will then be discounted to reflect the time value of money in terms of both future obligations and current service cost.

The rate used to discount post-employment benefit obligations (both funded and unfunded) is determined by reference to market yields at the end of the reporting period on high quality corporate bonds. For currencies for which there are no deep markets in such high-quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency should be used. IAS 19 notes that

bonds should match the currency in which pension payments are made (to reduce additional risk arising from foreign exchange fluctuations) and the bond terms should be consistent with cash requirements.

The contributions from employees and the company are invested by the pension plan in assets. These investments are ring-fenced, i.e. they are totally separate from the assets of the company itself and can only be used by the pension plan to pay pension obligations. A pension plan will hold assets in the form of a combination of equities, bonds, cash and investment funds.

Assets held in the plan must be measured at their fair value at the date of the statement of financial position, which would normally be the market value of the equities, bonds etc. that the pension scheme has invested in. Once this value is determined, the value of the plan assets should be offset against the value of its liabilities to identify whether the plan as a whole is in surplus or deficit.

Determining the amount of the net defined benefit liability (asset)

This step takes the amount of the deficit or surplus determined in (1) and adjusts it to reflect the impact of any asset ceiling that the plan is required to meet. An asset ceiling is an adjustment to reflect the actual value of plan assets and liabilities that relate to the company reporting the plan, rather than to the plan itself. Hence the asset ceiling is the present value of any economic benefits available to the company in the form of refunds from the plan or reductions in future contributions to the plan. Asset ceilings are not always relevant but are necessary in situations where the pension plan rules stipulate that any surplus belongs to the members of the plan, rather than the employer. In these situations, the surplus does not belong to the company, and so should not be recognised as a company asset. Asset ceilings may also have an impact on the valuation of any liability, and we will turn to that shortly.

A net defined benefit asset may arise where a defined benefit plan has been overfunded or where actuarial gains have arisen. An entity recognises a net defined benefit asset in such cases because:

i. The entity controls a resource, which is the ability to use the surplus to generate future benefits.

ii. That control is as a result of past events (contributions paid by the entity and service rendered by the employee); and

iii. Future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund.

The first thing to bear in mind is that pension plans do not need surpluses, and any amount in excess of obligations should in principle be refunded, either to the employer (often by reducing subsequent contributions), or to the plan's members. Thus IAS 19 requires plans to value the surplus at the lower of the surplus or the asset ceiling because, where asset ceilings are in place, these reduce the amount of surplus that may be available for the employer, or reporting company's use.

To understand how this effects pension disclosures we will look at an Example. A pension scheme has assets of 140 and its present obligations are valued at 100. The plan's rules state that any surplus belongs to its members. The pension disclosures in the notes would therefore show:

FV of pension assets	140
PV of pension obligations	(100)
Plan surplus	40
Asset ceiling adjustment	(40)
Pension asset on Statement of Financial Position	0

The asset ceiling is used here to eliminate the surplus that belongs to the plan's members, as this surplus is not an asset for the company. This adjustment is recognised in Other Comprehensive Income and cannot subsequently be reclassified to Profit or Loss.

Pension regulations in many countries (including the UK and US) require periodic assessment of pension funding (typically every 3 years). If the plan is underfunded, the company is required to commit to additional payments over a number of years to eliminate the deficit (this is often referred to as a recovery plan).

However, in the years between the funding assessments, changes in the value of the scheme assets or the value of the obligation may result in the committed recovery payments exceeding the size of the pension deficit. If the scheme rules prevent the company from avoiding these payments AND any surplus in the pension scheme belongs to the scheme members, rather than the company, then the asset ceiling would increase the size of the pension liability to reflect the PV of the remaining recovery payments.

The next two steps address how the impact of the surplus or deficit will be reflected in profit and loss and other comprehensive income, respectively.

Determining amounts to be recognised in profit or loss

The following amounts should be recognised in profit and loss

(a) current service cost.

(b) any past service cost and gain or loss on settlement.

(c) net interest on the net defined benefit liability (asset).

Current service cost is the amount that employees have earned for their service in the current reporting period.

Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods which results from any amendments to the plan. Such amendments arise from changes in the terms of the plan which have an impact on the amounts due in relation to prior periods. Net interest on the net defined benefit liability is the change during the period in the liability that arises from the passage of time. It comprises: interest income on plan assets, interest cost on the defined benefit obligation (representing the unwinding of the discount applied in calculating the present value of the obligation), and interest on the effect of the asset ceiling from Step 2.

These amounts are recognised in profit and loss because they represent actual income earned and expenditure incurred in the reporting period.

Determining the re-measurements of the net defined benefit liability (asset), to be recognised in other comprehensive income

These re-measurements comprise:

(a) actuarial gains and losses

(b) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset)

(c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset). Where an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.

Actuarial gains and losses result from increases or decreases in the present value of the defined benefit obligation because of changes in actuarial assumptions and experience adjustments. These can include changes in salaries, staff turnover, early retirement or even broader mortality rates, all of which would impact on the extent to which plan assets can meet plan liabilities. In determining the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation.

These changes, along with changes in asset ceilings are reported in other comprehensive income because they do not reflect income and expenditure incurred in the reporting period. 3.6 Defined Benefit Pension Disclosures

IAS 19 sets out the disclosure requirements for defined benefit pensions as comprising information that:

(a) explains the characteristics of its defined benefit plans and risks associated with them

(b) identifies and explains the amounts in its financial statements arising from its defined benefit plans

(c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

To meet these objectives an entity shall consider all the following:

(a) the level of detail necessary to satisfy the disclosure requirements

(b) how much emphasis to place on each of the various requirements

(c) how much aggregation or disaggregation to undertake

(d) whether users of financial statements need additional information to evaluate the quantitative information disclosed

The disclosures required to communicate the large amount of information discussed above are quite considerable, and financial statements will therefore incorporate an explanation of the nature of the plan along with several pages of tables, supported by contextual information sufficient to explain the figures presented. It is surprisingly difficult to find actual Examples of financial statements using IFRS which disclose defined benefit pensions, but this is really a product of this type of provision almost completely disappearing (at least from the private sector). Students wishing to see a visual summary of the requirements laid out in the approved format should refer to the IFRS Illustrative Examples available here: ***http://media.ifrs.org/ixbrl_Example11_2011-03-25.xhtml***

3.7 Share Based Payments

In a share-based payment transaction, a company acquires goods or services from a counterparty and in return, the company provides either equity instruments or cash equivalent to the value of these equity instruments. This value can be based on the entity's own equity instruments or those of another entity within the same group.

Entities sometimes use their shares, or options over their shares, as a form of currency. For Example, an early-stage entity, sometimes called a start-up entity, with limited cash might issue its shares in exchange for goods or services from a strategic partner. While this practice may help the start-up entity to manage its cash flow, the payment in shares may also be attractive as an investment to a vendor or service provider who thinks that the value of the shares may increase.

Another common scenario is the use of share-based compensation to remunerate employees. Share-based compensation plans can motivate employees to higher levels of performance and build a sense of shared ownership in the entity. They might be provided as a way of retaining key members of staff and as part of succession planning. Generally, share-based payment schemes provide employees with the right to receive equity in the entity or a cash payment based on the entity's share price if the performance of the entity exceeds predetermined levels. Typical performance measures include increases in earnings per share, revenue targets and market share.

The entity applies IFRS 2 ***Share-based payments*** to account for its share-based payment arrangements. The reason a specific IFRS Accounting standard is required for share based payments is that the recognition and measurement criteria vary to other employee benefits due to the way that they are earned and to the variability in value of the consideration to be given.

There are three main types of share-based payment transactions within the scope of IFRS 2:

- Equity-settled share-based payment transactions.
- Cash-settled share-based payment transactions.
- Share-based payment transactions with cash alternatives.

IFRS 2 is also applicable to group arrangements where the entity receiving the goods or services is different from the one settling the transaction.

The majority of share-based payment transactions aim to improve compensation packages of employees, particularly those in senior positions. As noted above, external parties such as vendors can also be counterparties in these transactions. When awarding employees, the value of a share-based payment transaction is measured at the date the transaction as agreed upon (i.e., the grant date), a principle known as 'grant date accounting'. In contrast, transactions with non-employees are measured at the date when the entity receives the corresponding goods or services.

The timing for recognising the cost of goods or services in a share-based payment transaction depends on the notion of 'vesting'. A share-based payment transaction becomes vested when the counterparty's entitlement is no longer contingent on fulfilling any vesting conditions, such as service or performance requirements. The cost is recognised over the vesting period, which is the timeframe required to fulfil all vesting conditions related to the share-based payment arrangement.

3.7.1 Equity settled transactions

Equity-settled transactions with employees and directors would normally be expensed and would be based on their fair value at the grant date. Fair value should be based on market price wherever this is possible. Many shares and share options will not be traded on an active market. If this is the case then valuation techniques, such as an option pricing model, would be used. IFRS 2 does not set out which pricing model should be used, but describes the factors that should be taken into account. It says that 'intrinsic value' should only be used where the fair value cannot be reliably estimated. Intrinsic value is the difference between the fair value of the shares and the price that is to be paid for the shares by the counterparty (the exercise price).

The objective of IFRS 2 is to determine and recognise the compensation costs over the period in which the services are rendered. For Example, if a company grant share options to employees that vest in the future only if they are still employed, then the accounting process is as follows:

The fair value of the options will be calculated at the date the options are granted (i.e., the grant date fair value).

This fair value will be charged to profit or loss equally over the vesting period, with adjustments made at each accounting date to reflect the best estimate of the number of options that will eventually vest.

Shareholders' equity will be increased by an amount equal to the charge in profit or loss. The charge in the profit or loss reflects the number of options vested. If employees decide not to exercise their options, because the share price is lower than the exercise price, then no adjustment is made to profit or loss. On early settlement of an award without replacement, a company should charge the balance that would have been charged over the remaining period.

Performance conditions

Schemes often contain conditions which must be met before there is entitlement to the shares called vesting conditions, including requirements to remain employed for a specific period. Conditions specifically related to the market price of the company's shares, for Example EPS reaching a specific level, are called market conditions and these are ignored for the purposes of estimating the number of equity shares that will vest. The logic behind this is that these conditions have already been taken into account when measuring the fair value of the share options.

3.7.2 Cash settled transactions

Cash settled share-based payment transactions occur where goods or services are paid for at amounts that are based on the price of the company's equity instruments. The expense for cash settled transactions is the cash paid by the company.

As an Example, share appreciation rights entitle employees to cash payments equal to the increase in the share price of a given number of the company's shares over a given period. This creates a liability, and the recognised cost is based on the fair value of the instrument at the reporting date. The fair value of the liability is re-measured at each reporting date until settlement with the changes in the fair value of the liability recognised in the profit or loss.

Credit Equity

For equity-settled share-based payment transactions, the credit entry is made to equity. While IFRS 2 does not specify which part of equity should receive this credit, it allows for transfers within equity. The method adopted by an entity often depends on national laws, which may establish rules regarding the presentation of items within equity (e.g., separate presentation of share capital equal to the face value of issued shares).

Some entities create a specific reserve within equity, labelled 'share-based payments', where all credit entries are made. Alternatively, some entities record the credit entry directly in retained earnings. This latter approach is often more practical in the long term, as entities won't be left with a separate equity item relating to arrangements that concluded many years prior to the reporting period

Modifications

Variations in the fair value of share-based schemes can arise naturally, for Example where more employees than are expected resign without exercising their rights to equity. In some cases, all or part of an equity-settled share-based payment scheme may not run its full course. The scheme may be cancelled, or a settlement may be reached. Alternatively, an entity might modify the terms and conditions, for Example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options.

A modification requires an entity to:

- Continue with the original accounting for the original share-based payment transaction; and
- Recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

This means that the accounting for the original share-based payment transaction does not stop as a result of the modification, nor is the previous accounting reversed. For Example, if an entity modifies a share-based payment transaction by replacing existing share options (tranche 1) with a new issue of share options (tranche 2), IFRS 2 requires an entity:

- Not to reverse any previous expense that has been recognised
- To continue to recognise the expense that would have arisen under the original share-based payment transaction (tranche 1). This means that the remaining unrecognised expense relating to tranche 1 will be expensed over the existing vesting service period (if any) and
- To expense the difference between the fair value of new options (tranche 2) and existing share options (tranche 1) over the vesting period (if any).

IFRS 2 provides additional guidance on modifications. In summary, whenever there is a modification to the terms of a share-based payment scheme, two valuations are required.

The first involves valuation of the existing rights (for Example, tranche 1) at the current date, immediately prior to the modification.

The second involves valuation of the amended rights (for Example, tranche 2) immediately after the modification.

If the new rights have a lower value than the current value of the previous rights, the modification (for Example, tranche 2) is ignored for accounting purposes (i.e. the original accounting for tranche 1 continues as if no change had ever taken place but nothing is recognised for tranche 2).

In most cases, the modification will increase the value of the rights. This mean an entity must continue accounting for the original scheme (tranche 1) plus recognise an additional charge for tranche 2 (which will be calculated as the difference between the two valuations). The incremental charge will be recognised either over the period of the remaining original vesting period or immediately if the modification occurs after the vesting date.

3.7.3 Cancellations and settlements

It is important to distinguish a cancellation or settlement from a failure to meet a vesting condition. For Example, where a vesting condition is a service condition that has not been met, it results in the reversal of charges that have previously been recognised. However, a cancellation or settlement leads to the acceleration of the charge that has not yet been recognised.

If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), IFRS 2 requires that:

(1) An entity must account for the cancellation or settlement as an acceleration of vesting (i.e. all of the charges that would otherwise have been spread over future accounting periods must be recognised immediately);

(2) Any payment made to the employee on the cancellation or settlement of the grant must be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess must be recognised as an expense; and

(3) If new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity accounts for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments (see Modifications). The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (2). If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity must account for those new equity instruments as a new grant of equity instruments.

3.7.4 Settlement of Share Based Payment in Groups

IFRS 2 Share-based Payment requires an entity to recognise as share-based payment transactions transfers of equity instruments of the entity's parent (or another entity in the

same group) to parties that have supplied goods or services to the entity.

Some constituents asked for guidance on whether, in the financial statements of an entity that receives services from its employees, similar arrangements that are cash-settled are also within the scope of IFRS 2.

For Example, how should the following arrangements be accounted for in the financial statements of a subsidiary that receives services from its employees:

- **Arrangement 1 –** the employees of the subsidiary will receive cash payments from the parent that are linked to the price of the equity instruments of the subsidiary.
- **Arrangement 2 –** the employees of the subsidiary will receive cash payments from the parent that are linked to the price of the equity instruments of the parent of the subsidiary.

Under either arrangement, the parent has an obligation to make the required cash payments to the employees. The subsidiary does not have any obligation to make such payments to its employees or provide them with its equity instruments.

3.7.5 Share Based Payment Disclosures

IFRS 2 requires extensive disclosures under three main headings, as follows:

- Information that enables users of financial statements to understand the nature and extent of the share-based payment transactions that existed during the period.
- Information that allows users of financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments which have been granted during the period, was determined.
- Information that allows users of financial statements to understand the effect of expenses, which have arisen from share-based payment transactions, on the entity's profit or loss in the period.

3.8 Other Long-Term Benefits

Other long-term benefits include the following items (if not expected to be settled within 12 months after the end of the period in which the employee renders the related service):

- Long-term paid absences such as long-service or sabbatical leave
- Jubilee or other long-service benefits
- Long-term disability benefits
- Profit-sharing and bonuses
- Deferred remuneration

Other long-term benefits give rise to a liability that should be discounted and thus share some of the characteristics of post-employment benefits, in respect of the need to accrue the benefit over a long period of time, and consider various qualification requirements that impact on the value of the associated liabilities, and assets, if recognised.

Where other long-term benefits are funded through a plan which holds dedicated assets, recognition and measurement will follow an approach which is a simplified application of the requirements for defined benefit pensions. IAS 19 justifies a simplified approach on the basis that this type of long-term benefit is subject to less uncertainty than defined benefit pension plans. The simplification applied is in respect of past service costs and gains or

losses on settlement. The specific requirements for this are outside the scope of this Unit and will not be included in the examination.

3.8.1 Disclosure

For other long-term employee benefits, an entity shall recognise the net total of the following amounts in profit or loss, except to the extent that another IFRS requires or permits their inclusion in the cost of an asset:

(a) service cost.

(b) net interest on the net defined benefit liability (asset).

(c) re-measurements of the net defined benefit liability (asset).

The standard provides guidance for disability benefits based on whether employees are required to accumulate a specific length of service to be eligible. IAS 19 states that if the level of benefit depends on the length of service, an obligation arises when the service is rendered. Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

Other than the requirements noted above, IAS 19 does not require specific disclosures about other long-term employee benefits.

3.9 Termination Benefits

IAS 19 deals with termination benefits separately from other employee benefits because the event that gives rise to an obligation is the termination of employment rather than employee's service. Termination benefits result from either an entity's decision to terminate the employment or an employee's decision to accept an entity's offer of benefits in exchange for termination of employment. Termination benefits are common when companies restructure or close specific business units.

It should be noted that termination benefits can sometimes include a benefit for the termination of employment and a separate benefit for the service of employees at the same time.

For Example, a company closes one of its factories and offers a bonus of 1 000 to all employees who will be retrenched. Because the company needs qualified people to remain in employment while the factory is being safely closed down, it offers an additional bonus of 2 000 to certain employees to remain with the company until the closure is completed. In this scenario, the bonus of 1 000 paid to all employees represents termination benefit and the additional 2 000 paid to the employees who stay until the closure is completed represents a benefit for the employee's service, and will be discounted and classified as other long-term benefits (assuming it will take at least a year to conduct the closure).

The timing of the recognition of liabilities and expenses for termination benefits will be the earlier of:

- When the company can no longer withdraw the offer of those benefits (either the termination plan exists or the employee accepts the offer of benefits) and

- When the company recognises cost for a restructuring (see IAS 37) that involves the payment of termination benefits.

Such benefits will be classified based on how long it is expected to take to settle the liability:

- If the termination benefits are expected to be settled wholly before 12 months after the end of the reporting period, then we should apply the requirements for short-term employee benefits (so recognise it as an expense to profit or loss on undiscounted basis)
- If the termination benefits are not expected to be settled wholly before 12 months after the end of the reporting period, then we should apply the requirements for other long-term employee benefits (so recognise it as an expense to profit or loss on discounted basis)

3.9.1 Disclosure

As is the case with short and other long term benefits (that are not funded), IAS 19 does not include specific disclosure requirements for termination benefits.

3.10 IAS 19 vs IPSAS 39

As was noted in the beginning of this section, IPSAS 39 is drawn primarily from IAS 19. The main differences between IPSAS 39 and IAS 19 are as follows:

- IPSAS 39 contains additional guidance on public sector bonus plans.
- For discounting post-employment obligations, IAS 19 requires entities to apply a discount rate based on yields on high quality corporate bonds consistent with the currency and estimated term of the post-employment benefit obligations. The requirement in IPSAS 39 is that entities apply a rate that reflects the time value of money. IPSAS 39 also contains a requirement that entities disclose the basis on which the discount rate has been determined.
- IPSAS 39 includes a rebuttable presumption that long-term disability payments are not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. Where this presumption is rebutted, the entity considers whether some or all long-term disability payments should be accounted for in the same way as for post-employment benefits. IAS 19 does not include such a rebuttable presumption.
- IPSAS 39 recognises re-measurements of the net defined benefit liability (asset) in net assets/equity. IAS 19 recognizes them in other comprehensive income.
- IPSAS 39 uses different terminology, in certain instances, from IAS 19. The most significant Examples are the use of the terms “revenue”, “controlling” and “controlled entities”. The equivalent terms in IAS 19 are “income”, “parent” and “subsidiaries”.

These differences are largely self-explanatory and arise from the particular circumstances within which public sector entities operate. For Example, public sector entities are not generally dependent on bond or equity markets for access to capital, and IPSAS refers to income rather than revenue, and does not mandate the presentation of net assets/equity.

D.4 Liabilities

4.1 Income Tax

You were introduced to the standard which covers income tax, IAS 12 Income taxes, in Financial Reporting, where you saw how the main entries for recording tax on the statement of profit or loss and statement of financial position were calculated. You will recall that deferred tax assets and liabilities represent accounting adjustments which address local tax rules that are inconsistent with the treatment required by IFRS Accounting Standards. In this section of the unit, we will be looking in more depth at deferred taxation, with specific focus on how temporary tax related differences will impact on the calculation of various balances.

As you learned in Financial Reporting, companies usually pay tax several months after the year-end and so may not know the exact liability for tax to include at the year-end. They therefore need to make an estimate of the liability. Any adjustment needed for paying more or less than the estimated amount is accounted for in the following year's statement of profit or loss.

The tax expense in the statement of profit or loss comprises the following three elements:

Current tax	**X**
Under/(over) provision from previous year	X/(X)
Increase/(decrease) in deferred taxation	X/(X)
Total tax expense	X

The total tax expense is shown on the face of the statement of profit or loss with the detail above in a note.

Current tax is the estimated tax payable for the current year, which is accounted for as:

Dr: Tax expense

Cr: Current tax (current liabilities)

Note that the current tax for the year is an estimate. When the tax is actually paid over to the tax authorities, companies will often end up paying more or less than the amount they accrued. The difference must be shown in the accounts for the year in which the payment is made, even though it relates to the previous year.

Tax balances in the statement of financial position comprise the following:

- Non-current liabilities – deferred tax
- Current liabilities – current tax payable

4.2 Deferred taxation

Deferred tax will usually be a credit balance, and each year it may need to increase or decrease.

If an increase to the deferred tax provision is required the adjustment would be:

Dr: Tax expense

Cr: Deferred tax

If a decrease to deferred tax provision is required the adjustment would be:

Dr: Deferred tax

Cr: Tax expense

Deferred tax is not a tax that is paid to the tax authorities, but rather an accruals-based accounting adjustment required by IAS 12 because the accounting treatment of an item differs from its taxation treatment. The taxation treatment is determined by the tax base of the asset or liability, which is the amount that can be attributed to it for tax purposes.

The specific calculation formulas for assets and liabilities are as follows:

- **The tax base of an asset** is the amount deductible for tax purposes against any taxable economic benefits flowing to an entity upon recovering the asset's carrying amount. If these benefits aren't taxable, the asset's tax base equals its carrying amount.
- **The tax base of a liability** is its carrying amount, less any amount deductible for tax purposes concerning that liability in future periods. For revenue received in advance, the resulting liability's tax base is its carrying amount, less any revenue amount not taxable in future.

For Example, the tax system of some countries does not allow companies to claim depreciation as an expense when calculating taxable profit. Instead, the system allows companies to claim 'capital allowances', the tax version of depreciation, on non-current assets, calculated at standard rates.

In general, the total depreciation charge in the statement of profit or loss for a non-current asset should be equal to the total capital allowances claimed over the life of that non-current asset. However, there may be *temporary differences* between the amount of depreciation charged for an accounting period, and the amount of capital allowances claimed in the tax computation for that period.

A liability for deferred tax arises if a company has claimed more in capital allowances for a non-current asset than it has charged as a depreciation expense in its accounts. This reflects the fact that in the future, the tax allowances given will be less than the accounting charge for depreciation and hence more tax will need to be paid to the tax authorities.

4.3 Recognition and measurement

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

The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an asset. When a tax loss is used to recover current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

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

(a) the initial recognition of goodwill, or

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

(i) is not a business combination

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

(iii) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

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

Deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. These may differ from current tax assets or liabilities if the tax authority announces a change in the tax rate to be applied in a subsequent period.

4.3.1 Limitations on recognition of tax assets

When tax assets arising from deductible temporary differences are reversed, the company will recognise deductions in determining the taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

A deferred tax asset is therefore recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.

In such circumstances, IAS 12 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised:

(a) Whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;

(b) Whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

(c) Whether the unused tax losses result from identifiable causes which are unlikely to recur;

(d) Whether tax planning opportunities are available to the entity that will create

taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not recognised.

4.3.2 Taxable temporary differences

The main possible causes of timing differences leading to deferred tax liabilities are:

- Accelerated capital allowances.
- Development costs capitalised and amortised in the financial statements but for tax purposes these costs are deducted from taxable profits as incurred.
- Revaluation gains. Assets are not revalued for tax purposes; this causes a difference between the tax treatment of assets and the accounting treatment of assets as the tax charge on the profit will not arise until the asset is sold but the gain has been recognised.
- Interest received included in financial statements on an accrual basis but not subject to tax until received.

There are other more specific circumstances which can give rise to temporary differences, identified in the standard as follows:

- The identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with IFRS 3 *Business Combinations*, but no equivalent adjustment is made for tax purposes.
- Goodwill arises in a business combination
- The tax base of an asset or liability on initial recognition differs from its initial carrying amount, for Example when an entity benefits from non-taxable government grants related to assets
- The carrying amount of investments in subsidiaries, branches and associates or interests in joint arrangements becomes different from the tax base of the investment or interest.

4.3.3 Disclosures

IAS 12 requires disclosure of the major components of tax expense and income, and provides the following Examples:

- Current tax expense (income)
- Any adjustments of taxes of prior periods
- Amount of deferred tax expense (income) relating to the origination and reversal of temporary differences
- Amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes
- Amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period
- Write down, or reversal of a previous write down, of a deferred tax asset

- Amount of tax expense (income) relating to changes in accounting policies and corrections of errors.

In addition, IAS 12 requires disclosure where relevant of information about the impact of tax on different elements of the financial statements, temporary differences, tax arising from business combinations and other tax effects that users should be aware of.

4.2 Leases

4.2.1 Introduction

As you learned in Financial Reporting, IFRS 16 Leases defines a lease as: "a contract, or part of a contract, that conveys the right-to-use an asset, the underlying asset, for a period of time in exchange for consideration".

A contract that includes a lease will have two parties: the *lessor*, who supplies the asset, and the *lessee*, who uses the asset.

A right-of-use asset is an asset that represents a lessee's right to use an underlying asset for the lease term. It will be associated with a lease liability that represents the amounts outstanding to the lessor over the lease term for use of the asset. The profit and loss will need to recognise the reduction in the value of the asset through depreciation, and the finance cost of acquiring the asset, comprising either the incremental borrowing rate or the rate implicit in the lease, over the term of the lease.

The first task in accounting for a lease is to determine whether the contract actually contains a lease or not. IFRS states that a contains a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration (usually a regular series of payments to the lessor).

The 'period of time' in the contract may be described in terms of the amount of use of an identified asset (for Example, the number of production units that an item of equipment will be used to produce), as well as the time period stipulated in the lease agreement.

4.2.2 Separating lease and non-lease components of a contract

Some contracts may involve complex arrangements, requiring the company to separately identify the lease component from any non-lease components, and account for these separately. For Example, a real estate lease may include common area maintenance services provided by the lessor – e.g. cleaning services, maintenance of a central heating plant, common area repairs etc. IFRS 16 generally requires a company to separate the lease and non-lease components of a contract. The lease component is accounted for under IFRS 16 and the non-lease components are accounted for in accordance with other applicable standards.

Only activities or costs that transfer a good or service to the lessee are identified as non-lease components e.g. costs incurred by the lessor for the benefit of a lessee like cleaning services, repairs, maintenance of the leased asset. Amounts payable for activities and costs that do not transfer a good or service are part of the total consideration and are allocated to the lease and non-lease components identified in the contract. Common Examples of activities (or costs of the lessor) that do not transfer a good or service to the lessee include the lessee's own payments for administrative tasks, insurance costs and property taxes.

IFRS 16 requires both the lessee and lessor to allocate consideration to the lease and non-lease components. Payments for activities and costs that do not transfer a good or service to the lessee do not give rise to a component and are included in the consideration that is allocated to the separate lease and non-lease components in the contract. Therefore, the consideration includes all payments in the contract – i.e. those that relate to lease and non-lease component(s), and other payments that relate to items such as taxes, which are not separate components.

The consideration in the contract is allocated to each lease and non-lease component. The allocation of the consideration is a two-step process:

1. Determine the stand-alone price for each component.
2. Allocate the consideration

4.3 Lessee Accounting

4.3.1 Initial Measurement of the right-of-use asset

At commencement of the lease the right-of-use asset is recognised at cost, which includes the following:

- the initial measurement of the lease liability
- lease payments made at or before the commencement dates
- any lease incentives received are deducted
- initial direct costs incurred by the lease (e.g., legal fees paid to a lawyer involved in the lease contract discussion)
- estimate of any costs to be incurred by the lessee in dismantling and removing the underlying asset or restoring the underlying to a condition in line with the lease terms

The recognition of this asset is an Example of 'substance over form'. This means that the transactions are recorded according to the economic reality and not just the legal form. For Example, with a lease, the lessee does not own the asset legally, but the economic substance is that they have the use of the asset, and will therefore include the asset in their financial statements.

4.3.2 Subsequent measurement of the right-of-use asset

The right-of-use asset should be measured under the cost model of IAS 16 *Property, plant and equipment*. When the right-of-use asset is an investment property or belongs to a class of assets that is held under the revaluation model then it should be revalued.

The asset should be depreciated over the shorter of:

- lease term, or
- the asset's useful life.

If the lease transfers legal ownership at the end of the lease term, or if there is a purchase option that they are expected to exercise, then it should be depreciated over its useful life.

4.3.3 Lease liability

The initial lease liability is measured at the present value of the lease payments that are

not paid at that date, which includes any expected payments at the end of the lease. The liability is discounted at the interest rate implicit in the lease. In other words, the lease liability is effectively treated as a financial liability which is measured at amortised cost, using the rate of interest implicit in the lease as the effective interest rate.

The lease payments made to the leasing company must be split between the finance element (which is included with finance costs on the statement of comprehensive income) and the principal element (which is the repayment of capital – the repayment reduces the liability within the statement of financial position).

The statement of profit or loss will include amounts within:

- Cost of sales, administration costs, or distribution costs – the depreciation charge for the year
- Finance costs – the interest element of the lease payment

The statement of financial position will include:

- Non-current assets (initial measurement or revalued amount less accumulated depreciation)
- Non-current liabilities (liability to lessor due in more than one year)
- Current liabilities (liability to lessor due in less than one year)

4.3.4 Recognition exemptions

IFRS 16 allows companies an exemption in the following situations:

- Leases that are less than 12 months long
- Leases for assets that are of a low value

If companies take this exemption, they recognise an expense in profit or loss on a straight-line basis. The asset is not recorded on the statement of financial position.

The short-term lease exemption may be applied to renewable and cancellable leases (e.g. month-to-month, evergreen leases) if the lessee is not reasonably certain to renew (or to continue, in the case of a termination option) the lease beyond 12 months.

IFRS 16 does not specify a threshold for the low-value exemption, but the basis for conclusions states that the Board 'had in mind' assets with a value of approximately USD 5 000 or less when they are new, such as small IT equipment (e.g. some laptops, desktops, tablets, mobile phones, individual printers) and some office furniture – i.e. 'inexpensive' assets. The exemption is not intended to cover more significant assets such as "brand new" cars and most photocopiers (regardless of their market value).

4.4 Lessor Accounting

The lessor follows a dual accounting approach for lease accounting. The lessor accounting treatment for the lease is based on either the lease being a finance lease or an operating lease.

The accounting is based on whether significant risks and rewards incidental to ownership of an underlying asset are transferred to the lessee, in which case the lease is classified as a finance lease. This is similar to the previous lease accounting requirements that applied to lessors. Where substantially all the risks and rewards are not transferred, the asset will be classed as an operating lease.

Generally, the presence of the following indicators, either individually or in combination, leads to a lease being classified as a finance lease:

- Transfer of ownership to the lessee either during or at the end of the lease term
- Existence of a purchase option that is reasonably certain to be exercised
- The lease term is for a major part of the economic life of the underlying asset
- The present value of the lease payments amounts to substantially all of the fair value of the underlying asset at inception of the lease
- The underlying asset is specialised for the use of the lessee without the need for significant modifications.

Lease classification is made at the inception date and is reassessed only if there is a lease modification. Changes in estimates (e.g. changes in estimates of the economic life or of the residual value of the underlying asset), or changes in circumstances (e.g. default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

4.4.1 Operating Leases

Generally, lease income from operating leases is recognised by the lessor on a straight-line basis from the commencement date over the lease term.

The initial direct costs incurred by the lessor in arranging an operating lease are added to the carrying amount of the underlying asset and cannot be recognised immediately as an expense. These initial direct costs are recognised as an expense on the same basis as the lease income. This will not necessarily be consistent with the basis on which the underlying asset is depreciated.

The lessor depreciates the underlying asset over the asset's useful life in a manner that is consistent with the depreciation policy that it applies to similar owned assets.

4.4.2 Finance Leases

At commencement, the lessor derecognises the underlying asset and recognises a finance lease receivable at an amount equal to its net investment in the lease, which comprises the present value of the lease payments and any unguaranteed residual value accruing to the lessor. The present value is calculated by discounting the lease payments and any unguaranteed residual value, at the interest rate implicit in the lease. Initial direct costs are included in the measurement of the finance lease receivable, because the interest rate implicit in the lease takes initial direct costs incurred into consideration.

The lessor recognises the difference between the carrying amount of the underlying asset and the finance lease receivable in profit or loss when recognising the finance lease receivable. This gain or loss is presented in profit or loss in the same line item as that in which the lessor presents gains or losses from sales of similar assets.

Over the lease term, the lessor accrues interest income on the net investment. The receipts under the lease are allocated between reducing the net investment and recognising finance income, to produce a constant rate of return on the net investment.

A lessor applies the derecognition and impairment requirements of IFRS 9 to the net investment in the lease. A lessor recognises any loss allowance on the finance lease receivable, applying IFRS 9. A lessor regularly reviews estimated unguaranteed residual values used in computing the gross investment in the lease. If there is a reduction in the estimated unguaranteed residual value, then the lessor revises the income allocation

over the lease term without changing the discount rate and immediately recognises any reduction in respect of amounts accrued.

4.5 Sale and Leaseback Transactions

In a sale-leaseback transaction, the seller of the asset becomes the lessee and the purchaser becomes the lessor. A sale-leaseback enables a company to sell an asset to raise capital, then lets the company lease that asset back from the purchaser, allowing them to continue to use the asset in exchange for the payment of rent. The economic terms of the lease are structured to be similar to those of a secured loan, with a portion of each rental payment including an implied financing cost, and the lessee typically has the right to acquire the leased asset. This implied financing cost is generally lower than the rate at which the seller/lessee could otherwise borrow, thus making these types of arrangements attractive to companies that already own or are acquiring tangible assets.

The accounting treatment of sale and leaseback transactions depends on whether or not the 'sale' constitutes the satisfaction of a relevant performance obligation under IFRS 15 *Revenue from contracts with customers*. The relevant performance obligation would be the effective 'transfer' of the asset to the lessor by the previous owner (now the lessee).

If the transaction does constitute a sale under IFRS 15 then the treatment is as follows:

- the seller-lessee shall measure the right-of use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained
- the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor
- the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in IFRS 16.

If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

- Any below-market terms shall be accounted for as a prepayment of lease payments, and
- Any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

If the transfer of an asset by the seller-lessee does not satisfy the requirements of IFRS 15, although a legal transfer of the asset has taken place, the seller does not 'transfer' the asset for accounting purposes. Instead, the seller continues to recognise it in the statement of financial position without adjustment. The 'sales proceeds' are recognised as a financial liability and accounted for by applying IFRS 9, Financial Instruments. In the same circumstances, the buyer recognises a financial asset equal to the "sales proceeds".

4.5.1 Disclosures

IFRS 16 is divided between accounting for lessees and lessors, and this is reflected in the disclosure requirements shown below:

Lessee Disclosures

A lessee shall disclose the following amounts for the reporting period:

- Depreciation charge for right-of-use assets by class of underlying asset;
- Interest expense on lease liabilities;
- The expense relating to short-term leases
- The expense relating to leases of low-value assets
- The expense relating to variable lease payments not included in the measurement of lease liabilities;
- Income from subleasing right-of-use assets;
- Total cash outflow for leases;
- Additions to right-of-use assets;
- Gains or losses arising from sale and leaseback transactions; and
- The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset

Lessor Disclosures

A lessor shall disclose the following amounts for the reporting period:

a) for finance leases:
   - Selling profit or loss;
   - Finance income on the net investment in the lease; and
   - Income relating to variable lease payments not included in the measurement of the net investment in the lease.

b) for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate

4.6 Provisions and Contingencies

4.6.1 Provisions

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines a provision as: 'a liability of uncertain timing or amount'. IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* includes an identical definition of a provision.

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefit. (IAS 37) IAS 37 distinguishes provisions from other liabilities such as trade payable and accruals. This is on the basis that for a provision there is uncertainty about the timing or amount of the future expenditure.

While uncertainty is clearly present in the case of certain accruals, the uncertainty is generally much less than for provisions.

IAS 37 states that a provision should be recognised as a liability in the financial statements when all three of the following criteria have been met:

- An entity has a present obligation as a result of a past obligating event; and
- It is probable that an outflow of economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the obligation.

Present obligation

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A constructive obligation arises when the business has created a valid expectation that they will act in a certain way in the future.

Probable outflow of economic benefits

There is no specific guidance of what percentage likelihood is required for an outflow to be probable. A probable outflow simply means that it is more likely than not that the entity will have to pay money to settle the obligation.

Reliable estimate

A provision can only be recognised if a reliable estimate of the amount involved can be made. The accounting entries required for a provision will be to create an expense in profit or loss and a provision as a liability on the statement of financial position. As provisions involve a degree of uncertainty, the exact amount paid may differ from the original provision, or the provision may need updating in subsequent years as more information is obtained.

4.6.2 Disclosures

IAS 37 required the following disclosures in respect of each class of provision:

- The carrying amount at the beginning and end of the period;
- Additional provisions made in the period, including increases to existing provisions;
- Amounts used (ie incurred and charged against the provision) during the period;
- Unused amounts reversed during the period; and
- The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required.

The notes to the financial statements relating to provisions shall include the following:

- A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and
- The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

4.6.3 Contingent liabilities

A contingent liability is defined by IAS 37 as:

- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control; or
- a present obligation that arises from past events but is not recognised because:
    - it is not probable that a transfer of economic benefits will be required to settle the obligation
    - the amount of the obligation cannot be measured with sufficient reliability.

A contingent liability will not be recognised in the financial statements as there is less certainty that it will occur or be settled than is the case for other liabilities such as trade payable.

In some circumstances, a contingent liability may need to be disclosed in the notes to the financial statements.

In general, 'probable' means more than 50% likely. If an obligation is probable, it is not a contingent liability; instead, a provision is needed.

Examples of contingent liabilities include loans guaranteed on behalf of third parties, and legal proceedings that are in process against a company where its legal advisors believe that it is unlikely (i.e. less than 50% probable) that any transfer of economic benefits will be required.

4.6.4 Disclosures

The required disclosures for a contingent liability are:

- A brief description of the nature of the contingent liability
- An estimate of its financial effect
- An indication of the uncertainties that exist
- The possibility of any reimbursement.

If the likelihood of settlement is remote, then no disclosure has to be made.

4.6.5 Contingent assets

The IAS 37 definition of a contingent asset is:

- a possible asset that arises from past events
- and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events not wholly within the organisation's control.

Contingent assets are not disclosed in the accounts unless it is virtually certain that economic benefit will be realised.

If it is probable (i.e. more than 50% probability) that economic benefit will flow from the asset, it is disclosed by a note to the accounts, which should follow the requirements for contingent liabilities.

D.5 Revenue and Income

5.1 Introduction

You were introduced to both revenue and income in Financial Reporting, the latter referring to the accounting requirements for entities in receipt of government grants. In this Unit we will be building on your understanding of the core principles and the five-step model for revenue by considering additional aspects of IFRS 15 *Revenue from contracts with customers* that were not previously covered.

5.1 Revenue

The standard we will focus on in this section is IFRS 15 Revenue from Contracts with Customers. Revenue is an important measure of a company's performance. It is used widely by investors and other users for making comparisons and investment decisions. You learned about IFRS 15 in Financial Reporting, where you saw that the main complexity in the standard relates to accounting for revenue that arises from contracts which offer a mix of goods and services to customers, for Example the provision of mobile phone handsets for which customers pay a monthly fee which also includes access to defined quantities of airtime and or data. This section will refresh the material you covered in Financial Reporting before going through some additional considerations which were not covered in that Module.

5.1.1 Core principles

The core principles of IFRS 15 are that:

- an entity should recognise revenue when it transfers goods or services to a customer based upon the amount of consideration (payment) to which the entity expects to be entitled from the customer
- the goods or services are transferred when the customer has control of them
- the disclosures are designed to help investors understand the nature, amount, timing and uncertainty of revenue.

Financial Reporting included this helpful table of definitions:

Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
Revenue	Income arising in the course of an entity's ordinary activities.
Income	Increases in economic benefits in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity (other than those from equity participants).
Stand-alone selling price	The price at which a good or service would be sold separately to a customer.

Performance obligation	A promise to transfer to the customer either: (i) a distinct (bundle of) goods or services, or (ii) a series of substantially the same distinct goods or services that have the same pattern of transfer to the customer, and the pattern of transfer is both over time and represents the progress towards complete satisfaction of the performance obligation.

5.1.2 Five-Step model

IFRS 15 establishes a five-step model that will apply to revenue earned from a contract with a customer, regardless of the type of revenue transaction or the industry. Every entity must follow this five-step model to comply with IFRS 15.

Step 1: Identify the contract(s) with the customer	A contract can be written, oral or implied, but for IFRS 15 to apply the following criteria must be met: • Parties have approved the contract and are committed to perform their responsibilities • Parties can identify the payment terms • The contract has commercial substance • It is probable that the consideration will be paid
Step 2: Identify the performance obligations in the contract	It is crucial to identify the performance obligations in the contract. This is because it is only when those performance obligations are satisfied that revenue can be recognised. Remember that the performance obligation is the promise to provide goods or services. A good or service is distinct if it can be sold separately. Key in identifying separate obligations is the "distinctiveness of the good or service".
Step 3: Determine the transaction price	A business needs to determine the amount of consideration it expects to receive in order to recognise revenue.
Step 4: Allocate the transaction price	For a contract that has more than one performance obligation, an entity should allocate the transaction price to each performance obligation. This allocation should be based on the relative stand-alone selling price of the goods or services.

Step 5: Recognise revenue when or as a performance obligation is satisfied	A performance obligation is satisfied when control of the goods or services is transferred to the customer. This can be satisfied at a point in time, or over a period of time. For a performance obligation to be satisfied over a period of time it must meet any one of the following criteria: 1. The customer simultaneously receives and consumes the benefit provided by the entity's performance as the entity performs it 2. The entity's performance creates or enhances an asset, for Example, work in progress, that the customer controls as the asset is created or enhanced 3. The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed. If any of these criteria are met, then revenue should be recognised over a period of time.

5.1.3 Performance obligations satisfied at a point in time

The key is to determine the date that control is transferred. IFRS 15 gives the following as indicators that control has been transferred:

- The entity has a present right to payment
- The entity has transferred physical possession of the asset
- The customer has accepted the asset
- The customer has the significant risk and rewards of the asset
- The customer has legal title to the asset.

5.1.4 Performance obligations recognised over a period of time

When a contract spans more than one accounting period, and it meets one of the criteria for revenue to be recognised over a period of time, the entity will need to determine how to best recognise the revenue over the appropriate period.

IFRS 15 states that this should be done by a method that best depicts the transfer of goods or services. This may be either:

- An input method – for Example based on the percentage of cost incurred to date compared to the total costs.
- An output method – for Example based on work certified to date.

5.1.5 Warranties

Some sales may include a warranty. The issue here is whether the warranties are separate performance obligations from the sale of the actual product or not.

IFRS 15 states that, if the customer can purchase the warranty separately, then it is a distinct service, and this should be accounted for as a separate performance obligation.

This would be an Example of a performance obligation that is satisfied over a period of time. Therefore, the revenue would be recognised over the period of the warranty.

If a warranty cannot be purchased separately then the warranty is accounted for under IAS 37 Provisions. This means the revenue is recognised at the time when the sale of the product is made, and a provision is set up for expected warranty costs.

5.1.6 Variable consideration

The transaction price reflects an entity's expectations about the consideration to which it will be entitled to receive from the customer. The standard provides the following requirements for determining whether consideration is variable and, if so, how it would be treated under the model:

If the consideration promised in a contract includes a variable amount, an entity should estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For Example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

(a) the customer has a valid expectation arising from an entity's customary business practices, published policies or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry or customer this offer may be referred to as a discount, rebate, refund or credit.

(b) other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

In other words, a contract may be variable even where there is no specific clause in the contract if the company has a history of providing discounts or concessions at the point of sale.

Variable consideration may also result from extended payment terms in a contract and any resulting uncertainty about whether the entity will be willing to accept a lower amount when it is paid in the future. That is, an entity has to evaluate whether the extended payment terms represent an implied price concession because the entity does not intend to, or will not be able to, collect all amounts due in future periods.

In order to calculate the amount of the variable consideration, the standard states that an entity should estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

(a) **The expected value**—the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

(b) **The most likely amount**—the most likely amount is the single most likely amount in a range of possible consideration amounts (i.e. the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for Example, an entity either achieves a performance bonus or does not).

An entity should apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity should consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management uses during the procurement process and in establishing prices for promised goods or services.

5.1.7 Sales with a significant financing component

In some instances, a company may make a sale that includes an implicit financing component. If the financing component is 'significant', IFRS 15 requires this to be recognised in the accounting for the sale. This is, in effect, adjusting for the effects of the time value of money.

Examples:

- Cash received in advance from buyer – vendor to recognise the finance cost and the increase in deferred revenue
- Cash received in arrears from buyer – vendor to recognise the finance income and the reduction in revenue

No adjustment for a financing component is needed if the payment is settled within one year of the goods or services being transferred to the buyer.

IFRS 15 does not require an adjustment for the following, as they do not result in a significant financing component:

- The customer has discretion over the timing of the transfer of control of the goods or services.
- The consideration is variable, and the amount or timing depends on factors outside of the control of parties.
- The difference between the consideration and cash selling price arises for other non-financing reasons (i.e. performance protection).

5.1.8 Discounts and consideration payable to a customer

Many entities make payments to their customers. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for Example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer).

An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained). If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers.

If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price.

If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price. Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognise the reduction of revenue when (or as) the later of either of the following events occurs:

(a) the entity recognises revenue for the transfer of the related goods or services to the customer; and

(b) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

5.1.9 Contract Modifications

Parties to an arrangement frequently agree to modify the scope or price (or both) of their contract. If that happens, an entity must determine whether the modification is accounted for as a new contract or as part of the existing contract. Generally, it is clear when a contract modification has taken place, but in some circumstances, that determination is more difficult.

IFRS 15 indicates that an entity may have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both). Instead of focusing on the finalisation of a modification, IFRS 15 focuses on the enforceability of the changes to the rights and obligations in the contract. Once an entity determines the revised rights and obligations are enforceable, it accounts for the contract modification.

Once an entity has determined that a contract has been modified, the entity determines the appropriate accounting treatment for the modification. Certain modifications are treated as separate stand-alone contracts, while others are combined with the original contract and accounted for in that manner. In addition, an entity accounts for some modifications on a prospective basis and others on a cumulative catch-up basis. The IASB developed different approaches to account for different types of modifications with an overall objective of faithfully depicting an entity's rights and obligations in each modified contract.

The standard sets out the following requirements for a company to account for a modification as a separate contract, rather than an extension of the existing contract:

An entity shall account for a contract modification as a separate contract if **both** of the following conditions are present:

(a) the scope of the contract increases because of the addition of promised goods or services that are distinct; and

(b) the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For Example, an entity may adjust the stand-alone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

If a contract modification is not accounted for as a separate contract, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (i.e. the remaining promised goods or services) in whichever of the following ways is applicable:

(a) An entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation) is the sum of:

  (i) the consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognised as revenue; and

  (ii) the consideration promised as part of the contract modification.

(b) An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (i.e. the adjustment to revenue is made on a cumulative catch-up basis).

(c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

5.1.10 Recognition of specified transactions

Transactions involving a principal and agent

When more than one party is involved in providing goods or services to a customer, IFRS 15 requires an entity to determine whether it is a principal or an agent in these transactions

by evaluating the nature of its promise to the customer. An entity is a principal (and, therefore, records revenue on a gross basis) if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent (and, therefore, records as revenue the net amount that it retains for its agency services) if its role is to arrange for another entity to provide the goods or services.

The standard emphasises that in order for an entity to conclude that it is providing the good or service to the customer, it must first control that good or service. That is, the entity cannot provide the good or service to a customer if the entity does not first control it. If an entity controls the good or service, the entity is a principal in the transaction. If an entity does not control the good or service before it is transferred to the customer, the entity is an agent in the transaction.

Where an entity itself manufactures a good or performs a service, it is always a principal if it transfers control of that good or service to another party. There is no need for such an entity to evaluate the principal versus agent application guidance because it transfers control of or provides its own good or service directly to its customer without the involvement of another party. For Example, if an entity transfers control of a good to an intermediary that is a principal in providing that good to an end-customer, the entity records revenue as a principal in the sale of the good to its customer (the intermediary).

The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognises. When the entity is the principal in the arrangement, the revenue recognised is the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognised is the net amount that the entity is entitled to retain in return for its services as the agent. The entity's fee or commission may be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

Options for additional goods or services

Many sales contracts give customers the option to acquire additional goods or services. These additional goods or services may be priced at a discount or may even be free of charge. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives, volume-tiered pricing structures, customer award credits (e.g., frequent flyer points) or contract renewal options (e.g., waiver of certain fees, reduced future rates). The existence of a non-refundable upfront fee may indicate that the contract includes a renewal option for future goods or services at a reduced price (e.g., if the customer renews the contract without the payment of an additional upfront fee). An entity would need to evaluate the renewal option to determine whether it is a material right.

When an entity grants a customer the option to acquire additional goods or services, that option is only a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer has, in effect, paid in advance for future goods or services. As such, the entity recognises revenue when those future goods or services are transferred or when the option expires.

The main challenge with this requirement is assessing whether an additional option represents a material right. This determination is important because it affects the

accounting and disclosures for the contract at inception and throughout the life of the contract.

Customers' unexercised rights

In certain industries, an entity collects non-refundable payments from its customers for goods or services that the customer has a right to receive in the future. However, a customer may ultimately leave that right unexercised (often referred to as 'breakage').

Retailers, for Example, frequently sell gift cards that may not be partially redeemed or completely redeemed and airlines sometimes sell non-refundable tickets to passengers who allow the tickets to expire unused. Under IFRS 15, when an entity receives consideration that is attributable to a customer's unexercised rights, the entity recognises a contract liability equal to the full amount prepaid by the customer for the performance obligation to transfer, or to stand ready to transfer, goods or services in the future.

An entity derecognises that contract liability (and recognises revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation. However, since entities may not be required by customers to fully satisfy their performance obligations, IFRS 15 requires that when an entity expects to be entitled to a breakage amount, the expected breakage would be recognised as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, it would not recognise any breakage amounts as revenue until the likelihood of the customer exercising its right becomes remote.

When estimating any breakage amount, an entity has to consider whether it is highly probable that a significant revenue reversal would occur for any estimated breakage amounts. Where an entity cannot state with high confidence that a reversal will occur it would not recognise those additional amounts of revenue arising from the unexercised rights.

Licensing

IFRS 15 provides application guidance for recognising revenue from licences of intellectual property that differs in some respects from the requirements for other promised goods or services. Given that licences include a wide array of features and economic characteristics, the IASB decided that an entity needs to evaluate the nature of its promise to grant a licence of intellectual property in order to determine whether the promise is satisfied (and revenue is recognised) over time or at a point in time. A licence provides either:

- A right to access the entity's intellectual property throughout the licence period, which results in revenue that is recognised over time; Or
- A right to use the entity's intellectual property as it exists at the point in time in which the licence is granted, which results in revenue that is recognised at a point in time.

IFRS 15 provides Examples of intellectual property that may be licensed to a customer, including software and technology, media and entertainment (e.g., motion pictures and music), franchises, patents, trademarks and copyrights.

Licences are frequently capable of being distinct (i.e., the first criteria of a distinct good or service) as a customer can often obtain at least some benefit from the licence of intellectual property on its own or with other readily available resources.

The standard includes as an Example a contract for a software licence that is transferred along with installation services, technical support and unspecified software updates.

The installation service is routinely performed by other entities and does not significantly modify the software. The software licence is delivered before the other goods or services and remains functional without the updates and technical support. The entity therefore concludes that the customer can benefit from each of the goods or services either on their own or together with other goods or services that are readily available. That is, each good or service, including the software licence, is capable of being distinct under IFRS 15.

If an entity determines that a licence of intellectual property and other promised goods or services are capable of being distinct, the second step in the evaluation is to determine whether they are distinct in the context of the contract. To do this an entity considers the indicators for whether the goods or services are not separately identifiable, including whether:

(1) The entity provides a significant service of integrating the licence and other goods or services into a combined output or outputs.

(2) The licence and other goods or services significantly modify or customise each other. Or

(3) The licence and other goods or services are highly interdependent or highly interrelated, such that the entity would not be able to fulfil its promise to transfer the licence independently of fulfilling its promise to transfer the other goods or services to the customer.

Once a license has been defined as distinct it must be assessed as a contract in its own terms, by applying the model to identify whether the associated performance obligation is realised over time, or at a point in time.

IFRS 15 requires that a licence that is not distinct from other promised goods or services in a contract be combined into a single performance obligation. It also identifies two Examples of licences of intellectual property that are not distinct from other goods or services, as follows:

- A licence that is a component of, and integral to the functionality of, a tangible good
- A licence that the customer can benefit from, but only in conjunction with a related service (e.g., as a result of the entity granting a licence, the customer has access to an online service provided by the entity)

In both Examples, a customer only benefits from the combined output of the licence of intellectual property and the related good or service. Therefore, the licence is not distinct and would be combined with those other promised goods or services in the contract. Where a license is not distinct it will be accounted for as a part of the larger provision of goods and or services of which it is a component.

Repurchase Agreements

Some agreements include repurchase provisions, either as part of a sales contract or as a separate contract that relates to the goods in the original agreement or similar goods. These provisions affect how an entity applies the requirements on control to affected transactions. IFRS 15 clarifies the types of arrangements that qualify as repurchase agreements:

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset

that was originally sold is a component. Repurchase agreements generally come in three forms:

- An entity's obligation to repurchase the asset (a forward);
- An entity's right to repurchase the asset (a call option); and
- An entity's obligation to repurchase the asset at the customer's request (a put option).

In order for an obligation or right to purchase an asset to be accounted for as a repurchase agreement under IFRS 15, it needs to exist at contract inception, either as a part of the same contract or in another contract.

Obligation or right to repurchase

If an entity has an obligation or a right to repurchase the asset, a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity shall account for the contract as either of the following:

- A lease in accordance with IFRS 16 *Leases* if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset; or
- A financing arrangement if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

When comparing the repurchase price with the selling price, an entity shall consider the time value of money.

Obligation to repurchase at request

IFRS 15 indicates that if the customer has the ability to require an entity to repurchase an asset (i.e., a put option) at a price lower than its original selling price, the entity considers, at contract inception, whether the customer has a significant economic incentive to exercise that right. That is, this determination influences whether the customer truly has control over the asset received. The determination of whether an entity has a significant economic incentive to exercise its right determines whether the arrangement is treated as a lease or a sale with the right of return. An entity must consider all relevant facts and circumstances to determine whether a customer has a significant economic incentive to exercise its right, including the relationship between the repurchase price to the expected market value (taking into consideration the effects of the time value of money) of the asset at the date of repurchase and the amount of time until the right expires.

If the repurchase price of an asset is equal to or greater than the original selling price, but less than or equal to the expected market value of the asset, it must also be accounted for as a sale of a product with a right of return, if the customer does not have a significant economic incentive to exercise its right.

If the customer has the ability to require an entity to repurchase the asset at a price equal to, or more than, the original selling price and the repurchase price is more than the expected market value of the asset, the contract is in effect a financing arrangement.

If the option lapses unexercised, an entity derecognises the liability and recognises revenue.

Consignment Arrangements

A consignment arrangement is a sale with a right of return and arises when a business delivers goods to another party, such as dealer or retailer that is for sale to an end customer.

This type of arrangement is often seen in the car industry when the car manufacturer delivers a car to a dealership. The car dealership then tries to sell the cars to customers.

IFRS 15 provides the following as indicators that a consignment arrangement exists:

- The product is controlled by the entity until a specific event occurs such as the sale of the product to a customer by the dealer or until a period expires
- The entity is able to require a return of the product or transfer to a third party
- The dealer does not have an unconditional obligation to pay for the product, although a deposit may be required.

Once a consignment arrangement is identified the key is then to determine when control is transferred as it is only at that point that revenue can be recognised.

Bill and Hold Arrangements

In some sales transactions, the selling entity fulfils its obligations and bills the customer for the work performed, but does not ship the goods until a later date. These transactions, often called bill-and-hold transactions, are usually designed this way at the request of the purchaser for a number of reasons, including its lack of storage capacity or its inability to use the goods until a later date. Whereas in a consignment sale physical delivery has occurred but control of the goods has not transferred to the customer, the opposite may be true in a bill-and-hold transaction.

According to IFRS 15, an entity shall determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product. For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

For a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

(a) the reason for the bill-and-hold arrangement must be substantive (for Example, the customer has requested the arrangement)

(b) the product must be identified separately as belonging to the customer

(c) the product currently must be ready for physical transfer to the customer

(d) the entity cannot have the ability to use the product or to direct it to another customer.

If an entity recognises revenue for the sale of a product on a bill-and-hold basis, the entity

shall consider whether it has remaining performance obligations to which the entity shall allocate a portion of the transaction price.

If an entity concludes that it can recognise revenue for a bill-and-hold transaction, IFRS 15 states that the entity needs to further consider whether it is also providing custodial services for the customer that would be identified as a separate performance obligation in the contract.

Contracts that are expected to make a loss.

Contracts that are expected to make a loss fall under the definition of an onerous contract set out in IAS 37 *Provisions, contingent liabilities and assets*. IFRS 15 and IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Thus, any revenue contract, particularly those where the performance obligations are delivered over a significant period, could become an onerous contract.

You will recall from IAS 37 that the correct treatment of an onerous contract is to recognise an impairment to the contract asset and a corresponding provision to be unwound as the revenue is matched to the excess obligations. Therefore, where a contract is expected to make a loss the accounting treatment will need to change from that applied under IFRS 15 to that applied under IAS 37.

5.1.11 Contract Costs

Contract costs are the costs that a company may incur in establishing and maintaining a revenue contract with a customer, with the obvious Example being sales commissions paid to employees for the initial commitment of the customer to the contract. IFRS 15 specifies that the incremental costs of obtaining a contract with a customer are recognised as an asset if the entity expects to recover them. An entity can expect to recover contract acquisition costs through direct recovery (i.e., reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). Incremental costs are those that an entity would not have incurred if the contract had not been obtained.

An entity only applies these requirements to costs incurred that relate to a contract with a customer that is within the scope of IFRS 15. When an entity recognises capitalised contract costs under IFRS 15, any such assets must be presented separately from contract assets and contract liabilities in the statement of financial position or disclosed separately in the notes to the financial statements (assuming they are material). Furthermore, entities must consider the requirements in IFRS 18 on classification of current assets when determining whether their contract cost assets are presented as current or non-current.

Costs incurred to obtain a contract that are not incremental costs must be expensed as incurred, unless they are explicitly chargeable to the customer (regardless of whether the contract is obtained).

5.1.12 Presentation in financial statements

Where a contract is in place, and revenue is being recognised over a period of time, there may be assets and/or liabilities associated with the contract, whether the input or output method is applied. These need to be included in the statement of financial position at the end of the year, alongside information in the statement of profit or loss on revenue, costs,

and profit or loss on the contract in the period.

Statement of profit or loss:

Revenue (total contract revenue x %)	X
Less cost of sales (total contract cost x %)	(X)
Profit	X

Statement of financial position:

Costs incurred	X
Profit recognised (in statement of profit or loss)	X
Less: Progress billings	(X)
Contract asset/(liability)	X/(X)

For contracts where performance obligations are satisfied over a period of time, the stage of completion is required to calculate how much revenue should be recognised to date. However, there is no requirement to calculate the estimated profit/loss on the contract as a whole (except to the extent of determining whether the contract is onerous).

5.1.13 Disclosures

Disclosure requirements concerning contracts with customers are outlined in IFRS 15. The IASB has emphasised that the extensive nature of the requirements and their irrelevance for certain entities means they should not be seen as a checklist, but as a guide. Essentially, entities should disclose material information about the financial impact of revenue contracts, categorised into the following key areas:

- Contracts with customers
- Disaggregation of revenue
- Contract balances
- Performance obligations
- Significant judgements made
- Contract costs recognised as assets

5.2 Government grants

The standard dealing with this topic is IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. We need to distinguish between government grants and government assistance:

Government Grants	Assistance by government in the form of transfer of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. To recognise a government grant, the entity must have reasonable assurance that: · it will comply with the conditions attached to the grant; and · the grant has been received or will be received.
Government Assistance	Action by government designed to provide economic benefit specific to an entity or range of entities under certain criteria. If a value cannot be reliably placed on the government assistance, or it cannot be distinguished from normal trading activity, then it is not included within the definition of government grants and assistance.

5.2.1 Accounting for government grants

IAS 20 requires that grants are recognised as income over the relevant periods, to match them with related costs.

This should be done on a systematic basis. The exact treatment of government grants will depend on whether the grant is a revenue grant or a capital grant.

Grant related to revenue costs	The grant should be credited to profit or loss as income in the period in which the associated expenditure is incurred (normally under 'other operating income'). Any government grant received, where the associated expenditure is yet to be incurred, and the terms of the grant do not require the immediate return of the funds to the government, should be credited to the statement of financial position as deferred income (within liabilities). This income is then credited to the profit or loss to match against the associated expenditure in the period that the expenditure is incurred.

Grant related to assets (capital expenditure)	Two methods allowed under IAS 20: 1. If the related asset is a "financial asset" - the grant is credited to the statement of financial position as deferred income (a liability). The grant is then credited 'other operating income' over the life of the asset on the same basis as the depreciation is charged on the asset. 2. If the related asset is a "non-financial asset" (e.g., PPE)- The grant is credited to the statement of financial position against the carrying value of the non-current asset i.e. reducing the value of the asset and hence resulting in a smaller depreciation charge each year. In the case of grants for non-depreciable assets, certain obligations may need to be fulfilled; in which case the grant should be recognised as income over the periods in which the cost of meeting the obligation is incurred.

5.2.2 Conditions attached to a grant

There may be a series of conditions attached to a grant (e.g. certain expenditure has to be made in order to qualify for the grant).

If the conditions for the grant have not been met in the year and part or the entire grant must be repaid, companies need to ensure that the repayable element is recognised as a payable.

5.2.3 Accounting for government assistance

Some forms of government assistance are excluded from the definition of government grants.

- Some forms of government assistance cannot reasonably have a value placed on them; for Example, free technical or marketing advice, provision of guarantees.
- There are transactions with government which cannot be distinguished from the entity's normal trading transactions; for Example, government procurement policy resulting in a portion of the entity's sales. Any segregation would be arbitrary.

It may be important to disclose information on such assistance. Where significant, the nature, extent and duration of the assistance should be disclosed.

5.2.4 IAS 20 Disclosures

Disclosure is required for the following:

- The accounting policy adopted by the entity, including the method of presentation.
- The nature and extent of government grants recognised, and other forms of assistance received.
- The unfulfilled conditions and other contingencies that are attached to recognised government assistance.

D.6 Fair Value Measurement

6.1 Introduction

You have encountered fair value in numerous different contexts throughout this workbook because it is the foundation used by IFRS 13 ***Fair Value Measurement*** on which assets and liabilities are valued. The core concept is explained well by the name: "fair," which assumes a win-win transaction or event between willing participants. Fair value is what all parties would consider a reasonable outlay or return for exchanging the asset or liability. How you convert this relatively simple idea into a value is somewhat more complicated, because you need to first define a market, and then think about who is participating in the market, what are their interests, and their liquidity, before you can try to estimate what those participants might be willing to exchange for your assets or liabilities. Sometimes this is straightforward, shares for companies traded on US stock exchanges can be easily priced because the market is deep and liquid and the same shares change hands every day; in smaller markets you may not be able to find anyone willing to purchase your assets.

During the discussion of financial instruments earlier in this workbook you were introduced to the "fair value hierarchy", which categorises the inputs or indicators used to determine value based on their quality (for Example, the information used to value US listed shares noted above would be at Level 1). The hierarchy is a practical tool that helps you decide how to account for assets and liabilities, and IFRS 13 ***Fair Value Measurement*** sets out the logic upon which the hierarchy operates. This section of the workbook will thus examine IFRS 13 in more detail, to help you understand how to correctly apply fair value when accounting for any asset or liability. It should be noted that IFRS 13 is essentially the default approach to determining fair value, which means that it is broadly consistent with other standards that have specific fair value requirements. IFRS 13 measurement and disclosure requirements, however, do not apply to:

- Share-based payment transactions within the scope of IFRS 2 *Share-based Payment*
- Leasing transactions accounted for in accordance with IFRS 16 *Leases*
- Measurements that have some similarities to fair value but are not fair value, such as net realisable value in IAS 2 *Inventories* or value in use in IAS 36 *Impairment of Assets*.

In addition, the IFRS 13 disclosure requirements are not applied to the following:

- Plan assets measured at fair value in accordance with IAS 19 *Employee Benefits*
- Retirement benefit plan investments measured at fair value in accordance with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*
- Assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36 *Impairment of Assets*.

The reason disclosure requirements are not applied is because the specific standard has more detailed disclosures. Similarly, where measurement requirements are not applied it is because of the approach in the specific standard is more appropriate for those transactions. Fair value is defined by IFRS 13 as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.'

IFRS 13 indicates that when measuring fair value, the following must be considered:

- The asset or liability being measured, including its condition, location and any restrictions on sale
- The principal (or most advantageous) market in which an orderly transaction would take place for the asset or liability
- For a non-financial asset, the highest and best use of the asset and whether the asset is used in combination with other assets or on a stand-alone basis
- The assumptions that market participants would use when pricing the asset or liability.

6.2 Transaction and Transport costs

The standard price in the principal (or most advantageous) market used to measure the fair value of the asset or liability is not adjusted for transaction costs.

Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability.

If location is a characteristic of the asset (as might be the case, for Example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

In short, because transaction costs are specific to a transaction, and not to any asset or liability, they should not be included when determining fair value. However, the standard allows transport costs to be included in fair value if "location is a characteristic of the asset". You will recall that commodities are raw materials used to manufacture consumer products, inputs in the production of other goods and services rather than finished goods sold to customers. By referring to commodities the standard is indicating that transporting raw materials from their origins, whether fields or mines or forests, to market is an expense that can be considered for fair value purposes. 6.3 Non-Financial Assets

When determining the fair value of non-financial assets, companies do not necessarily use the current utilisation of the asset as the basis for the valuation, as the company may not be putting it to its most economic use. In order to protect its competitive position, for Example, a company may intend to use an acquired intangible asset defensively by preventing others from using it. Even where the asset is unutilised the standard requires that the highest and best use of the asset forms the valuation base, as what matters when thinking about a market value is what others may be willing to pay for that asset, rather than the benefit it generates for the owner. A fair value measurement of a non-financial asset thus takes into account a market participant's (potential buyer's) ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

- A use that is physically-possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (e.g. the location or size of a property).
- A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset

(e.g. the zoning regulations applicable to a property).

- A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

As noted above, highest and best use is determined from the perspective of market participants, even if the entity intends a different use.

6.4 Liabilities

A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (e.g. equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an entity's own equity instrument assumes the following:

- A liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.
- An entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

One important factor to consider when measuring the fair value of a liability is the effect of the issuer's credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. The fair value of a liability should thus reflect the effect of what the standards refers to as "non-performance risk". Non-performance risk includes, but may not be limited to, an entity's own credit risk and the effect may differ depending on the liability, for Example:

- Whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability).
- The terms of credit enhancements related to the liability, if any.

6.5 Valuation techniques

The standard requires companies to use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

Three widely used valuation techniques are the market approach, the cost approach and the income approach. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.

The market approach	Uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business.

The cost approach	Reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
The income approach	Converts future amounts (e.g. cash flows or income and expenses) to a single discounted amount.

The cost approach does not use the cost incurred in acquiring a particular asset, but the cost that someone else would pay at the reporting date to acquire or construct an asset providing similar economic benefit. That is because a buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

When the income approach is used, the fair value measurement reflects current market expectations about the future amounts that are expected to flow from the asset or liability. The valuation techniques that can be used under the income approach include the following:

- Present value techniques
- Option pricing models, such as the Black-Scholes-Merton formula or a binomial model that incorporates present value techniques and reflect both the time value and the intrinsic value of an option
- The multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

6.6 Fair Value Hierarchy

The valuation techniques used and the inputs identified will determine the classification of the asset or liability under the fair value hierarchy. In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised within different levels of the fair value hierarchy, for Example a hundred hectares of prime agricultural land might have Level 1 inputs, while the orchard of valuable trees that occupies one hectare might have Level 3. In those cases, the fair value measurement is categorised in its entirety at the lowest level input that is significant to the entire measurement. Continuing the Example, one hectare of trees is probably not significant to ninety-nine hectares of farmland, meaning Level 1 would be appropriate for the entire asset. Assessing the significance of a particular input to the entire measurement requires judgement, taking into account factors specific to the asset or liability.

Level 1 input will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets (e.g. on different exchanges). Therefore, the emphasis within Level 1 is on determining both of the following:

- The principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.
- Whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date.

If the asset or liability has a specified contractual term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in markets that are not active

- Market-corroborated inputs
- Inputs other than quoted prices that are observable for the asset or liability, for Example:

(i) interest rates and yield curves observable at commonly quoted intervals

(ii) implied volatilities

(iii) credit spreads.

Level 3 unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique, or how reliable the underlying assumptions are.

A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. For Example, a risk adjustment to a value may be necessary when there is significant measurement uncertainty, which might arise from a decrease in the volume or level of activity when compared with the normal market. Companies should develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data.

6.7 Disclosures

IFRS 13 requires companies to disclose information that helps users of the financial statements to assess both of the following:

- For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.
- For recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

In other words, a company is required to explain how it has classified the inputs used to determine the fair value of assets and liabilities using the hierarchy, and show separately any amounts which pass through the statement of financial performance in relation to any assets and liabilities supported by Level 3 inputs. Since these valuations are the least well supported, it is logical to draw the user's attention to the impact that any fluctuations in value give rise to.

When developing their fair value disclosures, the standard requires a company to consider all the following:

- The level of detail necessary to satisfy the disclosure requirements
- How much emphasis to place on each of the various requirements
- How much aggregation or disaggregation to undertake
- Whether users of financial statements need additional information to evaluate the quantitative information disclosed.

D.7 Financial reporting for specific industries within the private sector

This section of the Unit provides coverage of some issues which are specific to certain industries within the private sector for which dedicated IFRS/IAS standards have been issued. 7.1 Retirement Benefit Plans

There are two standards which directly relate to reporting on retirement benefits: IAS 19 *Employee benefits*, which explains how to value plan assets and liabilities and account for changes in those values; and IAS 26 *Accounting and Reporting by Retirement Benefit Plans*, which explains the disclosure requirements applied in the financial statements of retirement benefit plans. Since we covered the recognition and measurement requirements for pension plans under D3 – Employee Rewards, this section will look at the specific requirements of IAS 26.

The requirements of IAS 26 are separated based on the type of pension plan, whether defined contribution or defined benefit. As you would expect, the requirements for defined benefit pensions are more demanding, but both types of plans have quite extensive disclosure requirements.

7.1.1 Defined contribution plans

The financial statements of a defined contribution plan should contain a statement of net assets available for benefits and a description of the funding policy.

The objective of reporting by a defined contribution plan is periodically to provide information about the plan and the performance of its investments. That objective is usually achieved by providing financial statements including the following:

(a) a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions

(b) statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period

(c) a description of the investment policies

7.1.2 Defined benefit plans

The financial statements of a defined benefit plan should contain either:

(a) a statement that shows:
  (i) the net assets available for benefits
  (ii) the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits
  (iii) the resulting excess or deficit; or

(b) a statement of net assets available for benefits including either:
  (i) a note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; or
  (ii) a reference to this information in an accompanying actuarial report.

If an actuarial valuation has not been prepared at the date of the financial statements, the most recent valuation shall be used as a base and the date of the valuation disclosed.

The financial statements should explain the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits, and the policy for the funding of promised benefits.

7.1.3 All pension plans

Retirement benefit plan investments should be carried at fair value. In the case of marketable securities fair value is market value. Where plan investments are held for which an estimate of fair value is not possible disclosure shall be made of the reason why fair value is not used.

The financial statements of a retirement benefit plan, whether defined benefit or defined contribution, should contain the following information:

(a) a statement of changes in net assets available for benefits

(b) material accounting policy information

(c) a description of the plan and the effect of any changes in the plan during the period.

Financial statements provided by retirement benefit plans should include the following, if applicable:

(a) a statement of net assets available for benefits disclosing:
  (i) assets at the end of the period suitably classified
  (ii) the basis of valuation of assets
  (iii) details of any single investment exceeding either 5% of the net assets available for benefits or 5% of any class or type of security
  (iv) details of any investment in the employer
  (v) liabilities other than the actuarial present value of promised retirement benefits

(b) a statement of changes in net assets available for benefits showing the following:
  (i) employer contributions
  (ii) employee contributions
  (iii) investment income such as interest and dividends
  (iv) other income
  (v) benefits paid or payable (analysed, for Example, as retirement, death and disability benefits, and lump sum payments)
  (vi) administrative expenses
  (vii) other expenses
  (viii) taxes on income
  (ix) profits and losses on disposal of investments and changes in value of investments
  (x) transfers from and to other plans

(c) a description of the funding policy;

(d) for defined benefit plans, the actuarial present value of promised retirement benefits (which may distinguish between vested benefits and non-vested benefits) based on the benefits promised under the terms of the plan, on service rendered to date and using either current salary levels or projected salary levels; this information may be included in an accompanying actuarial report to be read in conjunction with the related financial statements

(e) for defined benefit plans, a description of the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits.

7.2 Agriculture

You were introduced to agricultural assets in Financial Reporting, where you learned that the standards dealing with this type of asset are IAS 41 ***Agriculture*** and IPSAS 27 ***Agriculture***.

The two standards have similar scope, definitions, and accounting treatments for biological assets and agricultural produce. IPSAS 27 has some additional guidance on accounting for biological assets that are acquired at no charge, for a nominal charge, or through a non-exchange transaction.

The main issues addressed by IAS 41 are:

- When a biological asset or agricultural produce should be recognised on the statement of financial position
- At what value a recognised biological asset or agricultural produce should be measured
- How the differences in value of a recognised biological asset or agricultural produce between two-year end dates should be accounted for

You were also provided with the following table of definitions:

Term	Definition
Agricultural activity	The management by an entity of the biological transformation and harvest of biological assets for sale, distribution at no charge, or conversion into agricultural produce or additional biological assets for sale or distribution.
Agricultural produce	The harvested produce of the entity's biological assets.
Bearer plant	A living plant that is used in the production and supply of agricultural produce, is expected to bear produce for more than one period, and has a remote likelihood of being sold.
Biological asset	A living animal or plant.
Biological transformation	The process of growth, degeneration, production, procreation that cause changes in a biological asset.

Term	Definition
Harvest	The detachment of produce from a biological asset or the cessation of a biological asset's life processes.

One key point to recognise is that the standards separate the product of a plant from the plant itself, where the plant ("bearer plant") will generate a product over a period of years (the annual olive or grape harvest is not the same as the olive trees and grape vines). As was noted under PPE, above, the bearer plants are treated as PPE, while the produce, or harvest is treated using IAS 41.

IAS 41 is applied to agricultural produce, which is the harvested produce of the entity's biological assets, at the point of harvest. Thereafter, IAS 2 *Inventories* or another applicable Standard is applied. Accordingly, IAS 41 does not deal with the processing of agricultural produce after harvest; for Example, the processing of grapes into wine by a vintner who has grown the grapes. While such processing may be a logical and natural extension of agricultural activity, and the events taking place may bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity in this Standard.

7.2.1 Recognition

The approach to recognition is similar to the general principles set out in the *Conceptual Framework*, with some additional requirements in relation to control of the asset. The recognition of a biological asset or agricultural produce is only permitted when:

- The entity controls the asset as a result of past events.
- It is probable that future economic benefits or service potential associated with the asset will flow to the entity.
- The fair value or cost of the asset can be measured reliably.

7.2.2 Measurement

Biological assets are initially and subsequently measured at their fair value less costs to sell, unless fair value cannot be measured reliably.

Agricultural produce is measured at fair value less costs to sell *at the point of harvest.* Following harvest, this produce is treated as inventory and IAS 2 (or IPSAS 12) *Inventories* is used as a reference for identifying related costs.

In some instances, cost can be used to approximate to fair value: for Example, where little biological transformation has taken place since the initial costs were incurred, or the impact of any biological transformation is not expected to be material. If fair value cannot be determined reliably, cost may be used as the measure, and this is adjusted for accumulated depreciation and impairment losses.

It may also be necessary to combine assets together to determine fair value for biological assets: for Example, by identifying the fair value of land that includes a plantation of trees and deducting the value of undeveloped land (if this is known) to determine the value of the trees.

Gains and losses from biological assets are recognised through profit or loss (or 'surplus or deficit' under IPSAS 27). This can result from either the initial recognition of a biological asset at fair value or from a change in a biological asset's fair value less costs to sell at

the reporting date.

Gains and losses arising on initial recognition of agricultural produce at fair value less costs to sell are also recognised through profit or loss in the period in which these arise.

7.2.3 Disclosure

The main disclosure requirements for IAS 41 are as follows:

An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell of biological assets.

An entity shall provide a description of each group of biological assets. The disclosure may take the form of a narrative or quantified description.

7.3 Insurance Contracts

Insurance contracts are addressed by IFRS 17 *Insurance Contracts*, which establishes the principles for the recognition, measurement, presentation and disclosure of Insurance contracts within the scope of the standard. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.

An insurance contract is a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

An insurance contract may contain one or more components that would be within the scope of another standard if they were separate contracts. For Example, an insurance contract may include an investment component or a service component (or both). Insurance contracts require a specific standard because of the complexity of valuing the risk they represent to the insurance issuer.

IFRS 17 provides the criteria to determine when a non-insurance component is distinct from the host insurance contract. The areas to be considered in this determination are as follows:

(a) Apply IFRS 9 Financial Instruments to determine whether there is an embedded derivative to be separated and, if there is, how to account for such a derivative.

(b) Separate from a host insurance contract an investment component if, and only if, that investment component is distinct. The entity shall apply IFRS 9 to account for the separated investment component.

c) After performing the above steps, separate any promises to transfer distinct non-insurance goods or services. Such promises are accounted under IFRS 15 *Revenue from Contracts with Customers*.

7.3.1 Recognition

An entity shall recognise a group of insurance contracts it issues from the earliest of the following:

(a) the beginning of the coverage period of the group of contracts

(b) the date when the first payment from a policyholder in the group becomes due

(c) for a group of onerous contracts, when the group becomes onerous.

7.3.2 Measurement

On initial recognition, an entity shall measure a group of insurance contracts at the total of:

(a) the fulfilment cash flows ("FCF"), which comprise:

  (i) estimates of future cash flows;

  (ii) an adjustment to reflect the time value of money ("TVM") and the financial risks associated with the future cash flows

  (iii) a risk adjustment for non-financial risk

(b) the contractual service margin ("CSM").

An entity shall include all the future cash flows within the boundary of each contract in the group.

The estimates of future cash flows shall be current, explicit, unbiased, and reflect all the information available to the entity without undue cost and effort about the amount, timing and uncertainty of those future cash flows. They should reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices.

On subsequent measurement, the carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:

(a) the liability for remaining coverage comprising:

  (i) the FCF related to future services and

  (ii) the CSM of the group at that date

(b) the liability for incurred claims, comprising the FCF related to past service allocated to the group at that date.

7.3.3 Presentation

Presentation in the statement of financial position

An entity shall present separately in the statement of financial position the carrying amount of groups of:

(a) insurance contracts issued that are assets

(b) insurance contracts issued that are liabilities

(c) reinsurance contracts held that are assets

(d) reinsurance contracts held that are liabilities.

Recognition and presentation in the statement(s) of financial performance

An entity shall disaggregate the amounts recognised in the statement(s) of financial performance into:

(a) an insurance service result, comprising insurance revenue and insurance service expenses; and

(b) insurance finance income or expenses.

Income or expenses from reinsurance contracts held shall be presented separately from the expenses or income from insurance contracts issued.

7.3.4 Reinsurance Contracts

The requirements of IFRS 17 are modified for reinsurance contracts held. In estimating the present value of future expected cash flows for reinsurance contracts, entities use assumptions consistent with those used for related direct insurance contracts. Additionally, estimates include the risk of the reinsurer's non-performance.

The risk adjustment for non-financial risk is estimated to represent the transfer of risk from the holder of the reinsurance contract to the reinsurer.

On initial recognition, the CSM is determined similarly to that of direct insurance contracts issued, except that the CSM represents net gain or loss on purchasing reinsurance. On initial recognition, this net gain or loss is deferred, unless the net loss relates to events that occurred before purchasing a reinsurance contract (in which case it is expensed immediately).

Subsequently, reinsurance contracts held are accounted similarly to insurance contracts under the general model. Changes in reinsurer's risk of non-performance are reflected in profit or loss, and do not adjust the CSM.

7.3.5 Premium allocation approach

An entity may simplify the measurement of the liability for the remaining coverage of a group of insurance contracts using the Premium Allocation Approach (PAA) on the condition that, at the inception of the group:

(a) the entity reasonably expects that this will be a reasonable approximation of the general model, or

(b) the coverage period of each contract in the group is one year or less.

Where, at the inception of the group, an entity expects significant variances in the FCF during the period before a claim is incurred, such contracts are not eligible to apply the PAA.

Using the PAA, the liability for remaining coverage shall be initially recognised as the premiums, if any, received at initial recognition, minus any insurance acquisition cash flows. Subsequently the carrying amount of the liability is the carrying amount at the start of the reporting period plus the premiums received in the period, minus insurance acquisition cash flows, plus amortisation of acquisition cash flows, minus the amount recognised as insurance revenue for coverage provided in that period, and minus any investment component paid or transferred to the liability for incurred claims.

Practical expedients available under the PAA

If insurance contracts in the group have a significant financing component, the liability for remaining coverage needs to be discounted, however, this is not required if, at initial recognition, the entity expects that the time between providing each part of the coverage

and the due date of the related premium is no more than a year.

In applying PAA, an entity may choose to recognise any insurance acquisition cash flows as an expense when it incurs those costs, provided that the coverage period at initial recognition is no more than a year.

The simplifications arising from the PAA do not apply to the measurement of the group's liability for incurred claims, measured under the general model. However, there is no need to discount those cash flows if the balance is expected to be paid or received in one year or less from the date the claims are incurred.

7.3.6 Disclosures

The disclosure requirements of IFRS 17 are very extensive, since they aim to provide comprehensive information about the impact of insurance contracts on the financial position and performance of the insurance entity. To achieve that objective, IFRS 17 requires entities to disclose qualitative and quantitative information about:

- The amounts recognised in its financial statements for contracts within the scope of IFRS 17;
- The significant judgements, and changes in those judgements, made when applying IFRS 17; and
- The nature and extent of the risks from contracts within the scope of IFRS 17

The key components of the mandated disclosures consist of reconciliations that show how the net carrying amounts of contracts within the scope of IFRS 17 changed during the period because of cash flows and income and expenses recognised in the statement of financial performance. Separate reconciliations should be disclosed for insurance contracts issued and reinsurance contracts held.

7.4 Mining Companies

Mining companies often incur significant expenses in searching for and evaluating potential new mineral resources and IFRS 6 *Exploration for and Evaluation of Mineral Resources* has been issued to explain how to account for these expenditures. Essentially it provides rules appropriate to the industry for the recognition of an asset arising from these expenditures being deferred, as well as the subsequent measurement of any asset so recognised.

It should be noted that IFRS 6 is applied only in the very specific circumstances of exploration and not to exploitation of any mineral resources (which is likely to be accounted for under IAS 2 *Inventories*). Equally, it is necessary for exploration expenditures to lead to a future economic benefit in order for them to be recognised as assets. Companies should therefore not apply IFRS 6 to expenditures incurred:

(a) before the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area.

(b) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

Companies should determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources.

Some exploration and evaluation assets are treated as intangible assets (e.g. drilling rights), whereas others are tangible assets (e.g. vehicles and drilling rigs). To the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset. However, using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset.

Exploration and evaluation assets shall be measured at cost. They may be classified as tangible or intangible based on the nature of the assets acquired.

The following are Examples of expenditures that might be included in the initial measurement of cost of exploration and evaluation assets:

(a) acquisition of rights to explore

(b) topographical, geological, geochemical and geophysical studies

(c) exploratory drilling

(d) trenching

(e) sampling

(f) activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

An exploration and evaluation asset should no longer be classified as such when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Exploration and evaluation assets shall be assessed for impairment, and any impairment loss recognised, before reclassification.

Exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount. When this happens a company should measure, present and disclose any resulting impairment loss in accordance with IAS 36 *Impairment of Assets*.

7.4.1 Disclosures

IFRS 6 requires the following disclosures in respect of amounts relating to the exploration for and evaluation of mineral resources.

its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.

The amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

In addition, exploration and evaluation assets should be treated as a separate class of assets and the disclosures required by either IAS 16 or IAS 38 should be applied, based on asset classification.

D.8 Financial reporting for small and medium-sized entities

As discussed in Financial Reporting, there is no single definition of a Small and medium-sized entity (SME). However, SMEs can generally be thought of as companies which are a) privately owned and therefore not listed on any stock exchanges; and/or b) do not hold assets in a fiduciary capacity (e.g. banks). 8.1 Eligibility criteria

Most definitions based on size use measures such as number of employees, net assets total, or annual revenues. However, none of these measures apply well across national borders. The SMEs Standard is therefore intended for use by entities that have no public accountability (i.e. its debt or equity instruments are not publicly traded or holds assets in a fiduciary capacity e.g. most banks and financial institutions cannot be categorised as SMEs for accounting purposes).

Ultimately, the decision regarding which entities should use the IFRS for SMEs Accounting Standard stays with national regulatory authorities and national standard setters. These bodies will often specify more detailed eligibility criteria. If an entity opts to use the IFRS for SMEs Accounting Standard , it must follow the standard in its entirety - it cannot select between the requirements of the IFRS for SMEs Standard and those of full IFRS Standards.

8.2 Differences between full IFRS and IFRS for SMEs

It should be clear now that the requirements of Full IFRS are a significant demand on companies that seek to, or are required to, comply with them. While the IFRS framework as a whole provides a comprehensive and detailed set of requirements, and ensures that users of the financial statements are able to place reliance on the information provided by the financial statements based on IFRS, the resources required to comply fully with them are beyond the ability of many smaller companies. There are also some areas of IFRS that are arguably less relevant to small companies.

As a result of these concerns, the IFRS for Small and Medium-sized Enterprises (SMEs) was issued by the IASB in 2009, and was amended in 2015. While full IFRS Accounting standards consists of a set of separate standards on specific accounting topics and issues, the IFRS for SMEs is a single self-contained document, which is based on the accounting principles found in current IFRSs. The requirements, however, have been simplified to be more appropriate for smaller entities, and there are some topics that are not included within the SME standard, as they were deemed to be less relevant. For Example the following topics are excluded from the IFRS for SMEs:

- earnings per share
- interim financial reporting
- segment reporting
- insurance (because entities that issue insurance contracts are not eligible to use the standard), and
- assets held for sale.

Some IFRS accounting treatments are not allowable under the SMEs Standard. For Example, the capitalisation of borrowing and development costs is not permitted under the IFRS for SME, as such expenses have to be expensed to profit or loss.

Examples of simplified approach under SMEs Standard	
Borrowing costs	Borrowing costs cannot be capitalised, but must be charged as an expense in the statement of profit or loss in the year that they arise.

Examples of simplified approach under SMEs Standard	
Development costs	Under IAS 38 *Intangible assets*, development costs are distinguished from research costs and must be capitalised where certain criteria are met. Under the IFRS for SMEs, development costs are treated the same as research costs, and must be charged as an expense in the statement of profit or loss when they are incurred.
Financial instruments	All basic financial instruments are measured at amortised cost, using the effective interest method, except for investments in non-convertible and non-puttable ordinary and preference shares that are publicly traded or whose fair value can otherwise be measured reliably are measured at fair value through profit or loss. All amortised cost instruments must be tested for impairment. At the same time the standard simplifies the derecognition and disclosure requirements. The SME Standard separates basic and other financial instruments e.g. hedging instruments, swaps, options. However, the IFRS for SME still offers significant simplifications even for more complex financial instruments. SMEs can choose to apply the recognition and measurement requirements of IFRS 9 *Financial Instruments* if they so wish.
Goodwill and other indefinite-life intangibles	These are amortised over their useful lives, but if useful life cannot be reliably estimated, then 10 years will be deemed to be the useful life of the intangible asset for amortisation purposes.
Investment in associates and joint ventures	The cost model is permitted for investments in associates and joint ventures.

The IFRS for SMEs is a response to international demand from developed and emerging economies for a rigorous and common set of accounting standards for smaller and medium-sized businesses that is much simpler than full IFRS Standards. The IFRS for SMEs should provide improved comparability for users of financial statements while enhancing the overall confidence in the financial statements of SMEs, and reducing the significant costs involved of maintaining standards on a national basis.

The IASB is expected to limit revisions to the IFRS for SME to once every three years although the process means in reality the time frames are longer. The IASB are currently (2021) in the process of consulting on whether and how to align the IFRS for SME standard with the full IFRS standards to better serve the users and preparers of financial statements without causing undue cost and effort to SMEs.

There may be some important tax issues arising for those SMEs that have adopted the IFRS for SMEs and this has been cited as one of the main reasons why some SMEs have not adopted the IFRS for SME Accounting Standard.

D.9 Accounting for transactions in the public sector

Most IPSAS standards are based on an equivalent IFRS standard, with amendments where appropriate to ensure that the standard is relevant to the public sector.

There are some standards, however, that deal with transactions or events that do not have an equivalent IFRS, or where there is a marked difference between the IPSAS and IFRS approaches

The following IPSAS are discussed in more detail below:

- IPSAS 23 Revenue from Non-Exchange Transactions and IPSAS 9 Revenue from Exchange Transactions
- IPSAS 21 Impairment of Non-Cash-Generating Assets
- IPSAS 11 Construction Contracts
- IPSAS 42 Social Benefits

9.1 Revenue from Exchange Transactions

IPSAS 9 *Revenue from Exchange Transactions* is based on IAS 18 *Revenue*, which has been replaced by IFRS 15 *Revenue from contracts with customers* (as discussed above). In broad terms, the approach to recognition of revenue from sales, provision of services, and interest, royalties and dividends is very similar to the IFRS approach to these transactions.

All costs associated with the revenue should be accounted for in the same period as the revenue is recognised. This is commonly referred to as the matching of revenue and expenses.

IPSAS 9 includes two general conditions that must be met before any type of revenue can be recognised, i.e.:

- It is probable that future economic benefits or service potential will flow to the entity.
- The amount of revenue can be measured reliably.

In addition to these two conditions, there are additional conditions that apply to specific types of revenue, specifically sale of goods, rendering of services, and interest royalties and dividends. As you learned in Financial Reporting the requirements for these revenues all relate to determining the point where transfer of ownership occurs and measuring the associated costs and revenues.

9.2 Interest Royalties and Dividends

According to IPSAS 9, revenue from interest, royalties and dividends should be recognised using the following accounting treatments:

Interest should be recognised on a time proportion basis that takes into account the effective yield on the asset, which is the rate of interest required to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of the asset. Interest revenue includes the amount of amortisation of any discount, premium, or other difference between the initial carrying amount of a debt security and its amount at maturity.

Royalties should be recognised as they are earned in accordance with the substance of the relevant agreement.

Dividends or similar distributions shall be recognised when the shareholder's or the entity's right to receive payment is established.

9.3 Disclosures

IPSAS 9 requires the following disclosures in respect of exchange revenue:

- The accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- The amount of each significant category of revenue recognized during the period including revenue arising from:
  - (i) the rendering of services;
  - (ii) the sale of goods;
  - (iii) interest;
  - (iv) royalties; and
  - (v) dividends or their equivalents;
- The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

9.4 Non-exchange revenue

One of the main characteristics of public sector entities as a whole is that a major part of their revenue is received as taxation or other mandatory payments by citizens or companies, rather than being paid in exchange for good and services. Many public sector bodies also receive donations or grants. A major part of their expenditure involves making payments or providing services for no fee, a nominal amount, or an amount which will not recover costs. These may include payments to relieve poverty, debt forgiveness, and other social expenditures.

These 'non-exchange transactions', in which the parties do not make exchanges of approximately equal value, are a characteristic feature of public sector financial reporting. Non-exchange transactions arise rarely if at all in the private sector, and consequently there is no IFRS covering non-exchange transactions. After considering such transactions, the IPSAS Board developed a standard to prescribe the financial reporting requirements of revenue arising from non-exchange transactions.

> 'In a non-exchange transaction, an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without receiving approximately equal value in exchange'.

The objective of IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)* is to set out requirements for the financial reporting of non-exchange revenue. IPSAS 23 applies to revenues from the following transactions and events:

- Taxes, from whatever source.
- Other non-exchange revenue (called 'transfers' in the standard), such as grants, fines, bequests, gifts, donations, and services-in-kind.

The same principles apply to the recognition of revenue from non-exchange transactions as for other revenue. Revenue collected on behalf of third parties (including other government organisations) is not counted as part of the entity's revenue. Revenue is recognised when:

- It is probable that future economic benefits or service potential will flow to the entity.
- The amount of revenue can be measured reliably.

The principle underlying the recognition of revenue from non-exchange transactions is that if an entity receives an asset in a non-exchange transaction it recognises revenue in the same amount, provided that the asset can be measured reliably.

Assets are defined in IPSAS 1 as 'resources controlled by an entity as a result of past events and from which economic benefits or service potential are expected to flow to the entity'. In the case of a public sector entity, assets arising from non-exchange transactions can take a number of forms including cash, receivables, other assets that provide economic benefits, and assets that have service potential. Under accruals accounting, the public sector entity will recognise revenue when it directly exercises control over these resources, or has reliable information on enforceable claims on these resources.

Non-exchange revenue will typically include:

- Donations.
- Surrenders of taxes.
- Accounts receivable based on invoices, for Example for fines levied on offenders, or for settlement of tax balances.
- Accounts receivable from contracts or binding agreements, including grants from another level of government or from international donors.
- Estimates of taxes due based on estimates of the economic activity that gives rise to a requirement to pay tax.

Revenue should only be recognised when control has passed to the receiving entity, on the basis of information which is sufficiently reliable. Pledges, promises or announcements of intention to pay are not generally regarded as sufficient to ensure an enforceable claim and thus control of an asset.

There are three important situations where assets received are not reflected as non-exchange revenue.

1. ***Contributions from owners:*** These are disclosed separately and are not part of revenue. These occur when a contributing entity provides and designates funding or other assets as being a permanent contribution, establishing a financial interest in the net assets/equity of the receiving entity.
2. ***Advance receipts:*** An entity may receive an asset in advance of the period to which it relates. Such advance receipts generally relate to taxes, but IPSAS 23 also gives an Example of annual contributions received in the preceding year. In line with standard accruals principles, these advance receipts are treated as a liability until the taxable or other event triggering recognition occurs, and only at that point is revenue recognised.
3. ***Assets with linked obligations:*** The receipt of assets may give rise to a present obligation, in the form of a duty to act or perform in a certain way. In some cases, this will indicate that the asset has been exchanged for acceptance of an obligation, and normal accounting for exchange transactions should be followed. In other cases, it

is more helpful to treat the asset as being received as a non-exchange transaction, but to recognise a balancing liability in respect of the obligation.

9.4.1 Measurement

In line with standard requirements for recognition of revenue, it is necessary that the asset received and controlled by the entity can be measured reliably. Assets acquired through non-exchange transactions are measured at their fair value at the date of acquisition. Revenue is valued at the amount of the increase in assets, less any associated liability attached to the asset. Many such assets are in the form of cash received immediately or within a short period, and establishment of fair values will be straightforward. As with all receivables, questions of collectability due to disputes and delays in payments may need to be addressed. Liabilities relating to present obligations also need to be valued. Where non-performance of the obligation would in principle require the asset to be returned, these are valued at an amount equal to the asset value. The liability will be reduced when the events occur to discharge the obligation, and these will also result in recognition of the revenue.

9.4.2 Revenue from taxes

IPSAS 23 requires a public sector entity to recognise an asset in respect of taxes when the taxable event occurs and the asset recognition criteria (including control, expectation of future economic benefits or service potential, and reliable measurement) are met. Taxes are a major source of revenue for many governments and public sector entities. IPSAS 23 includes a definition of taxes as:

'Economic benefits or service potential compulsorily paid or payable to public sector entities, in accordance with laws and/or regulations, established to provide revenue to the government. Taxes do not include fines or other penalties imposed for breaches of the law'.

The taxable event will vary according to the type of tax levied and IPSAS 23 provides a list of Examples:

- **Income tax –** Earning of assessable income during the taxation period by the taxpayer.
- **Value added tax –** Undertaking of taxable activity during the taxation period by the taxpayer.
- **Goods and services tax –** Purchase or sale of taxable goods or services during the taxation period.
- **Customs duty –** Movement of dutiable goods or services across the customs boundary.
- **Death duty –** Death of a person owning taxable assets.
- **Property tax –** Passing of the date on which the tax is levied, or the period for which the tax is levied, if the tax is levied on a periodic basis.

IPSAS 23 requires that assets arising from taxation transactions to be measured at their fair value as at the date of acquisition. Assets arising from taxation transactions are measured at the best estimate of the inflow of resources to the entity.

IPSAS 23 describes key features of taxation issues in many jurisdictions that may serve to delay settlement of tax, may make the level of settlement uncertain, and may require the

development of statistical models or other estimation approaches. These include the long periods allowed for filing of returns, failures to file returns by the due date, complexities in tax law, and inherent problems in gathering relevant information.

Because of the need for governments to maintain cash flows from tax receipts, it is normal for tax authorities to require payments in advance, particularly from self-employed persons and businesses. IPSAS 23 makes it clear that the significant volume of advance tax receipts encountered in many jurisdictions should not be recognised as revenue until the tax is properly due. Governments applying accruals accounting should recognise tax revenue in line with the taxable events, applying tax rates to taxable income or assets.

The tax area is one where many (perhaps most) governments face significant practical difficulties in producing reliable estimates of total tax due and the likely level of bad debts. In many jurisdictions governments will not be able to estimate these even after collection processes have been completed; they may only be able to measure objectively and reliably the net amount of taxes collected.

Governments will often face additional constraints from limitations in the systems used to collect and account for tax receipts (whether their own or systems used by other entities collecting tax on behalf of government), which may not provide sufficient information on the period to which tax receipts relate.

For these reasons, many governments either do not account for tax revenue on an accrual basis, or provide accruals information which is limited due to difficulties in producing reliable estimates. IPSAS 23 recognises the difficulties and requires disclosure of information on 'missing' tax revenue.

Taxation revenue is determined at a gross amount. It should not be reduced for expenses paid through the tax system, nor should it be grossed up for the amount of tax expenditures.

9.4.3 Disclosures

IPSAS 23 requires the following disclosures:

- The amount of revenue from non-exchange transactions recognized during the period by major classes showing separately:
    - Taxes, showing separately major classes of taxes; and
    - Transfers, showing separately major classes of transfer revenue. • The amount of receivables recognized in respect of non-exchange revenue;
- The amount of liabilities recognized in respect of transferred assets subject to conditions;
- The amount of liabilities recognized in respect of concessionary loans that are subject to conditions on transferred assets;
- The amount of assets recognized that are subject to restrictions and the nature of those restrictions;
- The existence and amounts of any advance receipts in respect of non-exchange transactions; and
- The amount of any liabilities forgiven.

9.5 Construction Contracts

IPSAS 11 Construction Contracts provides guidance on how to allocate revenue and costs

to the relevant accounting periods, and in doing so enables us to spread the overall profit earned over the life of the contract. The guidance in IPSAS 11 follows the principles of revenue recognition contained in IAS 18 Revenue.

IPSAS 11 requires that the entity matches revenue and expenses over the life of a construction contract. In this way we are recognising profit over the life of the contract.

During the early stages of a contract, it may be too early to recognise any profit on that contract. In this situation, or where it is not possible to estimate the outcome reliably, the entity recognises matching amounts for contract revenue and costs, which results in zero profit in the period.

When calculating how much revenue and costs to include in the financial statements for the current accounting period, we must carefully consider the information that is available. In general, there are four ways in which the information can be used to calculate how much to include in revenue and costs for the current accounting period:

1. Information is available to determine the value of work certified and corresponding costs. This is the ideal information, since we are provided with information on the work completed during the current period and also on the corresponding costs that relate to that work.
4. Information is available to determine value of work certified only. We can use the figure for work certified to estimate the corresponding costs.
5. Information is available on the proportion of the contract that has been completed. We can use this information to estimate the revenues and costs that relate to the current accounting period.
6. Information only available on the costs incurred to date. We can use this information to establish that the contract is X% complete and use this to estimate work completed.

Note that the first of these is the most reliable basis for determining revenues and costs for the period. The other three are acceptable methods for estimating revenues and costs if the 'ideal' information is not readily available.

As soon as the entity becomes aware that a contract is likely to make a loss, it must provide for that loss in full. This is even if the contract is several years away from completion.

9.5.1 Disclosures

IPSAS 11 requires the following disclosures:

- The amount of contract revenue recognized as revenue in the period;
- The methods used to determine the contract revenue recognized in the period; and
- The methods used to determine the stage of completion of contracts in progress.

In addition, entities should disclose each of the following for contracts in progress at the reporting date:

- The aggregate amount of costs incurred and recognized surpluses (less recognised deficits) to date;
- The amount of advances received; and
- The amount of retentions.

9.6 Service Concession Arrangements

A service concession arrangement (SCA) is an arrangement (usually contractual) whereby a public sector entity issues a concession to a private sector entity under which the private sector entity will provide assets and related services to the public on behalf of the public entity. The two parties are referred to as the Grantor (who provides the concession – i.e. the public sector entity) and the Operator (who provides the service and/or assets – i.e., the private sector entity). Common Examples include private companies building and charging tolls for major roads, along with schools and telecommunication networks.

The accounting requirements for SCAs are set out in IPSAS 32 ***Service Concession Arrangements: Grantor*** (the private sector operator would use IFRIC 12 ***Service Concession Arrangements***, so there is no need for an IPSAS standard for the operator). IPSAS 32 defines a service concession arrangement as:

A binding arrangement between a grantor and an operator in which:

- The operator uses the service concession asset to provide a public service on behalf of the grantor for a specified period of time; and
- The operator is compensated for its services over the period of the service concession arrangement

At the end of the arrangement the residual interest in any assets constructed or transferred as part of the arrangement (e.g. the motorways, bridges or telecommunication networks) is typically controlled by the grantor, not the operator.

The key issue for both grantors and operators of SCAs is who recognises the SCA asset on their statement of financial position. The legal owner of the asset will be the operator, but legal ownership is not the only consideration when deciding who recognises the asset. IPSAS 32 provides two control tests:

1. The grantor controls or regulates what services the operator must provide with the infrastructure/service concession asset, to whom it must provide them, and at what price; and
2. The grantor controls – through ownership, beneficial entitlement or otherwise – any significant residual interest in the infrastructure/ service concession asset at the end of the term of the arrangement.

If both of these tests are met then the grantor recognises the SCA asset provided by the operator. (Note that these are the same tests as those set out in IFRIC 12 ***Service Concession Arrangements*** (a standard applicable to the operator – the private sector entity). So, in theory the private sector operator in any given arrangement will treat the SCA in a consistent manner in their IFRS financial statements to the public sector grantor in their IPSAS financial statements).

9.6.1 Accounting for SCAs

The grantor's treatment of an SCA which meets the two control tests is similar to the accounting principle underlying a lessee's treatment of a finance lease. Where these two tests are met, the grantor will initially recognise the asset at fair value, with a liability for the corresponding amount.

The nature of the liability, and the accounting treatment after initial recognition, depends on how the operator is compensated for providing the infrastructure/service concession asset and the related services. This compensation can arise from the grantor, or from

the users of the asset/services, and the treatment applied will depend on the source, as shown below:

	The grantor makes payments to the operator	The grantor gives the operator the right to charge service users (e.g. road tolls)
Nature of liability	The grantor recognises a financial liability, reflecting its obligation to make payments to the operator.	The grantor recognises a performance obligation, reflecting its obligation to make the infrastructure/service concession asset available to the operator.
Accounting treatment after initial recognition	Payments made to the operator are allocated into three elements: payment for services; a finance charge; and an element that reduces the finance liability.	The performance obligation is reduced as access to the infrastructure/service concession asset is provided. The grantor recognises the reduction in the performance obligation as revenue is generated over the service concession arrangement term.

Where the grantor makes payments to the operator, and also gives the operator the right to charge service users, the grantor will recognise both a financial liability and a performance obligation, and will account for these liabilities separately.

You can see in the table above that the accounting treatment after initial recognition is the same as for finance leases where the SCA requires that the grantor makes payments to the operator. However, where the SCA remunerates the operator by giving it the right to charge service users, the treatment is different, as shown in the worked Example below, because the grantor has no financial liability to the operator but instead must recognise a performance obligation.

9.6.2 Disclosures

IPSAS 32 requires that the grantor disclose the following information in respect of service concession arrangements in each reporting period:

(a) A description of the arrangement;

(b) Significant terms of the arrangement that may affect the amount, timing, and certainty of future cash flows;

(c) The nature and extent of:

- Rights to use specified assets;
- Rights to expect the operator to provide specified services in relation to the service concession arrangement;
- Service concession assets recognised as assets during the reporting period, including existing assets of the grantor reclassified as service concession assets;

- Rights to receive specified assets at the end of the service concession arrangement;
- Renewal and termination options;
- Other rights and obligations (e.g. major overhaul of service concession assets);
- Obligations to provide the operator with access to service concession assets or other revenue-generating assets;

(d) Changes in the arrangement occurring during the reporting period.

9.7 Impairment of assets

The first thing to remember is that IPSAS Accounting Standards have two standards that guide on the accounting for impairment of assets with one of the standards guiding the treatment for the impairment of cash-generating assets (i.e. IPSAS 26 *Impairment of Cash-Generating Assets*) and the other standard guiding the treatment for the impairment of non-cash-generating assets (IPSAS 21 *Impairment of Non-Cash-Generating Assets*).

IPSAS 21 is necessary for the public sector as most of its assets are normally used to deliver services rather than to generate revenue. There are, of course, exceptions to this general rule, hence the need for IPSAS 26 to guide on the accounting treatment for the impairment of cash-generating assets. Government entities do hold investment properties and some specific publicly funded entities may exist solely to manage or trade cash generating assets (government owned development corporations, for Example, are often profit seeking entities). There are no differences between accounting for cash generating assets under IPSAS 26 and IAS 36 *Impairment of assets*.

The differences between IPSAS and IAS relating to impairment of assets therefore arises from the need to account for the impairment of non-cash generating assets (these are assets used to deliver services). These differences comprise of:

- defining value in use;
- grouping assets into cash generating units; and
- external indicators of impairment having occurred.

We will review each of these in turn below:

Value in Use

You learned in Financial Reporting that IPSAS 21 allows several methods for estimating the value in use (present value of remaining service potential) for non-cash generating assets and these include:

- Depreciated replacement cost – the replacement cost is the asset's gross service potential and is depreciated to reflect the asset in its used condition. The cost is measured as the reproduction or replacement cost of the asset (whichever is lower).
- Restoration cost approach – the cost of restoring the service potential of an asset to its pre-impaired level. Under this approach, the present value of the remaining service potential is determined by subtracting the estimated restoration cost from the current cost of replacing the remaining service potential of the asset before impairment, which is usually the depreciated reproduction or replacement cost of the asset.

- Service units approach – the present value of the remaining service potential of the asset is determined by reducing the current cost of the remaining service potential of the asset before impairment to conform with the reduced number of service units expected from the asset in its impaired state.

Use of Cash Generating Units

The IPSAS standard on non-cash generating assets, IPSAS 21, only applies to individual assets. Under both IAS 36 and IPSAS 26, where it is not possible to determine the recoverable amount of an individual asset, then the recoverable amount of the asset's cash-generating unit will be determined. IPSAS 26 considered but did not adopt a "service-generating unit" in a non-cash generating environment because it determined that it is possible to identify the service potential of individual assets and the unit approach would introduce undue complexity. In other words, assets with service potential should not be viewed as parts of a larger interdependent system because it will be possible to individually value the service potential of each asset in such a unit.

Indicators of Impairment

As you saw in Financial Reporting, normally changes in market prices are an important external indicator of impairment. However, non-cash-generating assets do not normally have an active market, and IPSAS 21 therefore eliminates this indicator from its indicators of impairment. With that exception, the indicators of impairment are the same in IPSAS 21 and IPSAS 26 (and these are similar to the indicators given in IAS 36).

9.8 Social benefits

IPSAS 42 *Social Benefits* defines social benefits as cash transfers paid to specific individuals and/or households to mitigate the effect of a social risk.

Social risks are events or circumstances that relate to the characteristics of individuals and/or households (e.g. age, health, poverty, employment status), and may adversely affect the welfare of individuals and/or households either by imposing additional demands on their resources or by reducing their income.

Examples of social benefits that are mentioned in IPSAS 42 include state retirement benefits, disability benefits, income support and unemployment benefits.

IPSAS 42 requires an entity to recognize an expense and a liability for the next social benefit payment. This will usually be a short-term liability, as only the next payment of social benefit expenditure needs to be accounted for.

IPSAS 42 stems from the need to provide transparency around the nature and financial effects of social benefit schemes, and to better understand how these schemes impact the government's finances as a whole.

There are two approaches to accounting for social benefits that are set out in IPSAS 42, referred to as the general approach and the insurance approach. The latter approach can only be applied where the social benefit is fully funded from contributions and where the scheme is managed at arm's length.

9.8.1 Disclosures

The disclosure requirements of IPSAS 42 essentially require the entity to present the impact of the provision of social benefits on its financial performance and position. They vary

based on the approach used.

Under the insurance approach, the entity should disclose:

- The basis for determining that the insurance approach is appropriate;
- The information required by the relevant international or national accounting standard dealing with insurance contracts; and
- The nature of the social benefits provided by the schemes, key features of the social benefit schemes and any material changes anticipated.

Under the general approach, the entity should disclose information that explains the characteristics of its social benefit schemes; and the demographic, economic and other external factors that may affect its social benefit schemes.

Summary of Unit D and key learning outcomes

Unit D deals with the key competency 'Apply judgement to complex financial reporting issues for corporate entities and public sector organisations. In this unit, we looked at the following learning outcomes:

Learning outcome	
Non-Current and Current Assets	You should now be able to account for the recognition, measurement, depreciation, impairment, revaluation, and disposal of current and non-current assets.
Financial Instruments	You should now be able to discuss and apply key definitions, recognition and measurement criteria and disclosure requirements for a range of financial instruments, including credit impaired assets, derivatives and hedge accounting.
Employee Rewards	You should now be able to discuss and apply the accounting treatment for different types of employee rewards, including defined benefit pension plans and share based payment schemes.
Liabilities	You should now be able to discuss and apply the recognition and measurement criteria for income tax, deferred tax and leases, including sale and leaseback arrangements.
Revenue and Income	You should now be able to discuss and account for revenue transactions, including contract modifications, specified transactions and contract costs.
Fair Value Measurement	You should now be able to explain how IFRS 13 is applied, including valuation techniques and disclosure requirements.

Learning outcome	
Financial reporting for specific industries within the private sector	You should now be able to discuss and apply the requirements under specific standards for retirement benefit plans, agricultural businesses, insurance contracts and mineral exploration.
Financial reporting for small and medium-sized entities	You should now be able to explain the eligibility requirement for the IFRS for SMEs and the main features of the simplified requirements.
Accounting for transactions in the public sector	You should now be able to explain and apply the accounting treatment for revenue from both exchange and non-exchange transactions, as well as construction contracts, service concession arrangements and social benefits.

Quiz questions

Question 1 Capitalisation Costs (D.1)

A company is building a factory to produce widgets. The following related costs have been incurred during construction to date:

Land survey and environmental assessment	250,000
Construction materials	2,500,000
Transport of construction materials	300,000
Consulting engineer's fees	100,000
Project management costs incurred by Human Resources	25,000
Wages of construction labourers	120,000
Interest due on loan of 1 000 000, half of which has been used to fund the new factory and half for other purposes.	50,000
TOTAL	3,345,000

What amount should be capitalised?

Question 2 Component Accounting (D.1)

Company B runs an airline and has just acquired a new aircraft for 50 million. Company B's aircraft comprises three physical components: an airframe valued at 25 million with a 20-year useful life, engines valued at 20 million with a 10-year useful life, and interior fittings valued at 5 million with a useful life of 5 years. If it applies component accounting to the aircraft, it will calculate separate depreciation charges for each component by dividing its cost by its useful life and adding these together for the annual total. If it does not apply component accounting, it will instead divide the total cost by the useful life of the longest-lived component.

What is the resulting depreciation charge when correctly applying component accounting?

Question 3 Calculating a revaluation (D.1)

At 31 December 20X4 Company B owned a building that had cost 750,000 10 years ago. It has depreciated the building on a straight-line basis with a useful life of 50 years.

On 1 January 20X5 a revaluation to 1,000,000 was recognised. At this date the building had a remaining useful life of 40 years.

The company's policy is to eliminate all previously recognised accumulated depreciation upon revaluation.

What are the correct journal entries for the recalculation?

Question 4 Building Held for Sale (D.1)

Company A owns a building which it has used for many years as a factory. On 1 January

20X4 the building had a carrying value of 15 million with an estimated useful economic life of 15 years. Company A uses the cost model under IAS 16 to account for buildings.

On 1 April 20X4 Company A commenced operations in a new building, and the old one was placed on the market as it was no longer being used. The estimated proceeds of sale were 13 million, less selling costs of 0.2 million. It was seen as highly probable at that date that the building would sell at that price.

By year end, 31 December 20X4, the building remained unsold, so Company A reduced the asking price to 11 million. The estimate of selling costs remained the same. The directors of Company A believed at that date it was highly probable the sale would occur within 12 months at the lower price.

Explain how the old building should be accounted for by Company A for the year ended 31 December 20X4.

Question 5 PPE Disclosure Note (D.1)

The following entries have been extracted from Company D's trial balance at 31 December 20X5:

	Dr	Cr
Land and Buildings – at previous revaluation	118,000	
Plant and Machinery – at cost	76,350	
Accumulated depreciation: buildings (at 1 Jan 20X5)		24,500
Accumulated depreciation: plant and machinery (at 1 Jan 20X5)		15,400

The following additional information is available for non-current assets:

1. Land is valued at 20,000 and is considered to have an infinite useful economic life.
2. Buildings are revalued regularly in line with IAS 16. They have been valued at 105,000 as at 31 December 20X5. Depreciation is to be charged based on the year-end value.
3. Buildings are depreciated on a straight-line basis over their estimated useful economic life. At 1 January 20X5 their useful economic life was estimated to be 20 years.
4. Plant and machinery with original cost of 15,000 was disposed of during 20X5. Accumulated depreciation on this asset at 1 January 20X5 was 7,500. The asset was sold for 9,000. No entries have been made yet in respect of these adjustments.
5. Plant and machinery is depreciated using the reducing balance method at 15%.
6. Assets are not depreciated in the year of disposal.

Prepare the IAS 16 disclosure note for tangible non-current assets.

Question 6 Intellectual property (D.1)

Company A is undertaking a review of the intellectual property it has acquired as a result of it purchasing Company B. The accountants have accumulated all the information

pertaining to the costs of the following items:

1. The Company B newsletter, distributed monthly for free to credit customers informing them of market and product developments
2. A patent with 10 years remaining which covers Company B's main product
3. Company B's self-developed customer management system
4. The database of Company B's customers

Which of the above listed items would be accounted for under IAS 38?

Question 7 Capitalisation of expenses (D.1)

Company C is developing a new line of pharmaceuticals and have spent 2 million up to 1 January 20X5. On 1 January 20X5 following promising results from the trials, the board gave approval to fully fund the rest of the project and spent a further 1 million to 1 April 20X5. On 1 April 20X5 problems were discovered in the trials and approval was not given from the medical regulator for use of the pharmaceuticals.

Company C then spent an additional 1 million to 1 July 20X5 to meet the regulator's objections, at which point approval was given. From 1 July 20X5 to 1 October 20X5 Company C spent a final 1.5 million putting the product into the final finished stage of development. The new pharmaceuticals are expected to generate revenues in excess of 20 million and have a useful life of five years.

How much of the 2+1+1+1.5m = 5.5m total costs can be capitalised under IAS 38?

Question 8 Investment property (D.1)

Company D owns a large commercial plot which it has subdivided in order to use half of the plot for its corporate headquarters and to lease the second half to generate rental income. Company D provides its tenants with security, maintenance and cleaning services which add approximately 15% to the lease cost for the tenants. The directors propose to measure the investment property at fair value as they expect the land to increase in value.

Can Company D classify the unused portion of its plot as an investment property?

Question 9 Investment property (D.1)

Company D has been very successful and the directors have decided to move their HQ to a new larger plot more centrally located. They intend to retain the existing plot and convert the owner-occupied section into offices for rental. This section of the plot will be prepared in order for it to be classified as investment property. The fair value of the HQ section of the plot is 1.5 million, while its carrying value as PPE is 1.35 million.

What changes will be recognised in Company D's financial statements in respect of this transfer?

Question 10 Calculation of impairment (D.1)

A piece of machinery was originally acquired for 100,000. It was expected to have a useful life of ten years and no residual value. It is depreciated on a straight-line basis.

At the start of year six, there was a downturn in demand due to a competitor product entering the market, and this has led to an impairment of the machinery. The impairment

has been calculated as being 20,000, although it is expected that the asset will continue to be productive at this level for its remaining five-year life.

What are the correct journal entries for the charges to the profit and loss statement for the impairment and depreciation?

Question 11 Identifying Financial Instruments (D.2)

1) A supermarket company anticipates rising prices for wheat and so enters into a forward contract for the provision of wheat based on its estimate of demand over the next six months.

Is this forward contract a financial instrument?

2) Which of the following meets the definition of a financial instrument?
   (a) Accounts payable
   (b) Cash
   (c) Loan guarantees
   (d) Shares
   (e) Property
   (f) Work in progress

Question 12 Cash flow hedge accounting (D.2)

On 1 December 20X4 a Rwandan company forecasts a significant sale in Tanzania which it expects to complete in 6 months. A hedging arrangement would be beneficial to reduce uncertainty about the value the company will receive in FRW when the contract is completed. The company therefore enters into a foreign currency forward contract with its bank to sell the 11 million TSHS it expects to receive for 8 million FRW on 31 May 20X5. This will allow the company to receive 8 million FRW irrespective of movements in the exchange rate. The following additional information is available:

- The functional currency of the company is FRW;
- The sale of 11 million. TSHS is expected in 6 months;
- Start date: 1 December 20X4, end date: 31 May 20X5;

On 31 December 20X5, due to changes in the exchange rate between FRW and TSHS, the fair value of the forward contract is a gain of 150,000 FRW; the fair value of the anticipated sale is a corresponding loss of 150,000 FRW. On 31 May 20X5 the exchange spot rate is 1.5 TSHS/FRW

What entries are needed to record this arrangement?

Question 13 Amortisation of financial assets (D.3)

Company B issues debentures with a total par value of 50,000 on Jan 1 20X4 redeemable in three years and an annual interest rate or coupon of 8%, to be paid at the end of each year. The company pays an upfront fee of 2,000 to issue the debentures and the net proceeds are therefore 48,000.

The effective interest rate for the debentures is 9.59%.

At initial recognition the debentures are recognised at fair value less transaction costs.

What are the correct ledger entries?

Question 14 Expected credit losses (D.3)

Company A has a two-year loan receivable from a customer with a gross carrying amount of 2 million and interest rate of 1% per annum payable in two annual instalments.

At a reporting date, Company A has assessed that there has been no significant increase in credit risk from initial recognition. The loan is therefore classified in terms of credit risk under Stage 1, which means that the ECL will be calculated as the expected loss over the next 12 months.

The PD within 12 months has been calculated based on historical data at 2% and LGD is also calculated based on historical data is 5%.

What is the ECL discounted to?

Question 15 Employee benefits (D.3)

Company A is a small tech start up that provides its 20 employees with a number of different benefits. All employees are entitled each year to:

- 25 days annual leave which accumulates up to a maximum of 40 days.
- 8 days non accumulating sick leave which must be supported by a doctor's note.
- A share of the company profits equal to 3% of net profits, divided equally between all eligible employees.

The following additional information is available:

- On average one day of annual and sick leave is worth 100
- The average accumulated leave is 10 days per employee
- The company's net profits at year end 20X4 were 500 000

Assuming that the profit share has not been paid at the reporting date, what is the value of the liability?

Question 15 Pension schemes (D.3)

A company pension has assets of 70 and total obligations of 130 at its funding valuation (i.e. a funding deficit of 60), so has agreed to recovery payments of 20 per year for the next 3 years. The plan rules state that recovery payments cannot be avoided once committed and any surplus belongs to the members of the pension plan.

A year later, the pension deficit falls to 30 as the plan assets have increased in value (and also because the company has made its first recovery payment), but the company is still committed to making the remaining recovery payments of 40.

How should the pension disclosures in the notes be shown?

Question 16 Pension plan (D.3)

Company E has a defined benefit pension plan and the accountants have gathered the necessary information from actuaries and internal records to classify the relevant cash flows and balances under IAS 16. In respect of year end 20X4, the following information has been provided:

Current and past service cost	0.5m
Fair Value of the defined benefit asset	2m
Net interest on the defined benefit asset	0.2m
Present Value of defined benefit obligations	1.5m

Given the above information, what entries should be made on the statement of financial position and statement of financial performance?

Question 17 Deferred taxation (D.4)

In 20X4, Entity A purchases a fixed asset for 1 000. With a useful life of 5 years, the annual depreciation charge under IAS 16 is 200. However, for tax purposes, Entity A can claim a 500 depreciation charge for the first 2 years. The entity generates an annual revenue of 800, taxable concurrently with IFRS recognition, at a 20% tax rate.

How should Entity A calculate the income tax payable to authorities?

Question 18 Inventory (D.4)

On 1 June 20X6, a company purchased inventory and paid for it by issuing shares to the supplier with a fair value of 6.3 million. The fair value of the inventory on 1 June 20X6 was 6m.

How will this transaction be dealt with in the financial statements?

Question 19 Share options (D.4)

A company grants 2 000 share options to each of its three directors on 1 January 20X6. The options will vest on 31 December 20X8 if the directors are still employed and if the company's share price reaches 14 per share. The fair value of each option on 1 January 20X6 is 10.

The share price at 31 December 20X6 is 8 and it is not anticipated that it will rise over the next two years. At 31 December 20X6, it is anticipated that only two directors will still be employed on 31 December 20X8.

How will the share options be treated in the financial statements for the year ended 31 December 20X6?

Question 20 Share appreciation (D.4)

Jay is a public limited company with a year end of 31 July 20X6. on 1 August 20X5, it granted 300 share appreciation rights to each of its 500 employees. The vesting date is 31 July 20X7. The fair value of each share appreciation right on 31 July 20X6 is 15.

At 31 July 20X6, management believe that 80% of the employees will still be employed on 31 July 20X7.

How will the transaction be recorded in the year ended 31 July 20X6?

Question 21 Lease (D.4)

Company A enters into a three-year lease of an apartment. The apartment is in a multi-tenant building that includes shared facilities (e.g. a swimming pool and garden). In addition to the monthly lease payments, the contract includes an additional fee of 2,000 per quarter for the upkeep of the communal areas, maintenance and security. This fee does not cover costs for non-routine and 'major' maintenance, which are billed to tenants separately.

At commencement, the timing and extent of the landlord's performance of common area maintenance is unknown (e.g. because it's difficult to predict how many repairs will be needed). However, the lessor has committed to keep the building and common areas well maintained. Company A determines that the common area maintenance is a separate non-lease component because it transfers a good or service to them other than the right to use the apartment. That is, Company A receives a service that it would otherwise have to pay for separately (e.g. if its plumbing required repairs).

How should Company A allocate the total contract consideration?

Question 22 Non-cancellable lease (D.4)

Company D enters into a non-cancellable lease contract with Company E under which Company E leases non-specialised equipment from Company D for five years. The economic life of the equipment is estimated to be 15 years and legal title will remain with Company D. The lease contract contains no purchase, renewal or early termination options. The fair value of the equipment is 100,000 and the present value of the lease payments amounts to 50,000.

In assessing the classification of the lease, Company D notes that:

- The lease does not transfer ownership of the equipment to Company E
- Company E has no option to purchase the equipment
- The lease term is for one-third of the economic life of the equipment, which is less than the major part of the economic life
- The present value of the lease payments amounts to 50% of the fair value of the equipment, which is less than substantially all of the fair value
- The equipment is not specialised.

How should company D classify the lease?

Question 23 Fair value (D.4)

Company B sells a building to Company C for cash of 4.5 million, which is the fair value of the building. Immediately before the transaction, the carrying amount of the building in the financial statements of Company B was 3.5 million. At the same time, Company B enters into a contract with Company C for the right to use the building for 20 years, with annual payments of 200,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Company B satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15. Accordingly, Companies B and C account for the transaction as a sale and leaseback.

How would this be recognised in the financial statements of Company B?

Question 24 Performance bonus (D.5)

Company E enters into a contract with Company F to build an asset for 100,000 with a performance bonus of 50,000 that will be paid based on the timing of completion. The amount of the performance bonus decreases by 10% per week for every week beyond the agreed-upon completion date. The contract requirements are similar to contracts Company E has performed previously, and management believes that such experience is predictive for this contract. Company E concludes that the expected value method is most predictive in this case.

Company E estimates that there is a 60% probability that the contract will be completed by the agreed-upon completion date, a 30% probability that it will be completed one week late, and a 10% probability that it will be completed two weeks late.

How should Company E determine the transaction price?

Question 26 Transfer of assets (D.5)

Company F enters into a contract with a customer to build and supply a new machine. Control over the completed machine will pass to the customer in two years (which is the point in time at which Company F's performance obligation will be satisfied).

The contract contains two payment options allowing the customer to pay:

- 5 million in two years (when it obtains control of the machine), or
- 4 million at inception of the contract.

The customer decides to take the option of paying 4 million at inception.

What journal entries should Company F make in its accounts to reflect this transaction?

Question 27 Contract modification (D.5)

Company G enters into an arrangement with a customer to sell 100 machines for 100,000 (1000 per good). The goods are distinct and are transferred to the customer over a six-month period. The parties modify the contract in the fourth month to sell an additional 20 goods for 950 each. The price of the additional goods represents the standalone selling price on the modification date.

Should Company G account for the modification as a separate contract?

Question 28 Recognition of specific transactions (D.5)

Company H negotiates with major airlines to obtain access to airline tickets at reduced rates and sells the tickets to end consumers through its website. Company H contracts with airlines to buy a specific number of tickets at agreed-upon rates and must pay for those tickets regardless of whether it is able to resell them. End consumers visiting Company H's website search Company H's available tickets. Company H has discretion in establishing the prices for the tickets it sells to the end consumers.

Company H is responsible for delivering the ticket to the end consumer. Company H will also assist the end consumer in resolving complaints with the service provided by the airlines. The airline is responsible for fulfilling all other obligations associated with the ticket, including the air travel and related services (that is, the flight), and remedies for service dissatisfaction.

Is Company H the principal or an agent for the sale of an airline ticket to an end consumer?

Question 29 Licensing (D.5)

Example

Company M enters into a contract with its customer for on-site data analytics software and cloud data storage. The on-site software utilises the customer's data stored on the cloud to provide data analysis. The software can also utilise data stored on the customer's premises or data stored by other vendors.

Is the software license distinct from the cloud storage?

Question 30 Repurchase agreement (D.5)

Company M is a car manufacturer that contracts with an independent reseller to sell 40 units of a particular car model at a price of 20,000 per unit. At the reseller's request, Company M agrees to repurchase any units six months after the date of the original sale. The agreement stipulates the vehicles will be repurchased at a value of 19,000 per unit. At the time of repurchase, the market value in six months is expected to be 16,000 per unit.

How should this transaction be classified using IFRS 15?

Question 31 Fair value (D.6)

Company J has an asset that is sold in two different markets with similar volume of activities but with different prices. Company J enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. There is no principal market for the asset.

	Market A	Market B
Price	**27**	**25**
Transport Costs	**(3)**	**(2)**
Transaction Costs	**(3)**	**(1)**
	21	**22**

In market A, the price that would be received is 27; transaction costs in that market are 3; and the costs to transport the asset to that market are 3 (that is, the net amount that would be received in market A is 21). In market B, the price that would be received is 25; transaction costs in that market are 1; and the costs to transport the asset to that market are 2 (that is, the net amount that would be received in market B is 22).

What is the fair value of the asset?

Question 32 Agriculture industry (D.7)

Cattle Company

Company A raises cattle, slaughters them at its abattoirs and sells the carcasses to the local meat market. **Which of these activities are in the scope of IAS 41?**

Question 33 Wine industry (D.7)

Wine Company

Company B grows vines, harvests the grapes and produces wine. **Which of these activities are in the scope of IAS 41?**

Question 34 Public sector (D.9)

An entity agrees to construct and operate a section of motorway on behalf of the national roads authority. The fair value of the infrastructure/service concession asset is 300 million. The service concession arrangement runs for 10 years and will commence at the start of Year 2. The infrastructure/ service concession asset is made available for use at the end of Year 1.

The entity (i.e. the operator) will generate revenue from tolls charged to users of the road. The estimated useful economic life of the infrastructure/service concession asset is 15 years. Assuming performance of the service concession arrangement is as estimated, what information will the operator's financial statements contain?

Unit E: Financial Statements of Group Entities

Learning outcomes

E.1	Business combinations and consolidation
E.2	Associates and joint arrangements
E.3	Changes in group structures
E.4	International operations
E.5	Public sector combinations

Introduction to Unit E

In Financial Reporting you were introduced to the key concepts underlying accounting for groups of companies. The issue that we need to understand is common to many of the standards: ensuring that the financial statements of an entity include all its assets and liabilities, expenses and revenues, irrespective of the specific form that those elements take. Historically, companies have often created or acquired companies or other Special-Purpose Vehicle (SPV) entities in order, for Example, to use cash productively by investing in another profitable business, or to expand into a new market by taking over an already established company. Apart from the many legitimate reasons for establishing ownership relations with other companies, groups can also allow, through clever accounting, a company to reduce its apparent exposure to risk or debt. This type of financial statement manipulation has led to some spectacular financial crashes, including Enron, more than 20 years ago. Enron used the so-called Special Purpose Vehicles to hide toxic liabilities that arose from excessive trading in e-commerce companies around the time of the dot.com collapse during 2000/2001. In 2008 SPVs again played a role in helping misrepresent the risk that investors exposed themselves to by purchasing sub-prime mortgage-based products of various exotic flavours. It is thus not surprising that the IASB issued an updated group accounting standard in May 2011, IFRS 10 *Consolidated Financial Statements*, that you learned about in Financial Reporting. Indeed, this area of accounting is covered by several related standards, as follows:

- IAS 27 (revised) Separate Financial Statements
- IAS 28 (revised) Investments in Associates and Joint Ventures
- IFRS 3 Business Combinations
- IFRS 10 Consolidated Financial Statements
- IFRS 11 Joint Arrangements
- IFRS 12 Disclosure of Interests in Other Entities

Each of these standards complements each other, in the sense that they separately address specific issues that these categories represent, although not all groups will apply all the standards, with the exception of IFRS 12, which deals with disclosures. Unlike Financial Reporting, in this Unit we will be looking at the differences between these standards and their IPSAS equivalents, later on.

We will start by focusing on IFRS 10 ***Consolidated Financial Statements***, since this standard defines control, and control is a fundamental concept underlying the application of the other standards. The objective of IFRS 10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10:

- Requires a parent entity (an entity that controls one or more other entities) to present consolidated financial statements
- Defines the principle of control, and establishes control as the basis for consolidation
- Set out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee
- Sets out the accounting requirements for the preparation of consolidated financial statements
- Defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.

We will therefore be discussing the various complexities involved in properly applying IFRS 10 and its related standards to business combinations and consolidation. Following that we will look in turn at associates and joint arrangements (the latter were only referred to in passing in Financial Reporting); accounting for changes in group structures; and international operations; before we close with public sector consolidation, where we will look at the differences in approach. This Unit builds directly on the content in Unit D of Financial Reporting, but there is little repetition, as most of this Unit's content is new. That said, it represents an additive expansion of the previous material, because you have already learned all the key concepts. Whereas previously your exam only required you to present consolidated financial statements with one subsidiary, in this exam you will need to combine more than one entity, whether subsidiary, associate or joint venture. The mechanics of the process, remain exactly the same, the challenge will be in remembering to apply the appropriate rule based on the nature of the relationship.

E.1 Business combinations and consolidation

The first part of this Unit will look at some of the theoretical concepts and issues that are key to understanding how to account for consolidation, before undertaking a simple Example of a more complex group. Some of this material is part of what you have already learned in Financial Reporting, and we will only repeat key details; in other cases the material will be new, either in whole or in part.

1.1 Control

You have already been introduced to the concept of "control", since it is impossible to discuss these standards without appreciating it. The concept can be explained most easily by applying it to companies that have an ownership relationship between them. Note that control assumes at least two parties: the investor who controls and the investee who is controlled. In both cases these are companies or some similar structure, such as a SPV entities. The table below from Financial Reporting highlights the two main categories of relationship:

Subsidiary	An entity that is controlled by another entity. (IFRS 10) The subsidiary is the investee, i.e. the company that is being controlled by the parent.	An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. (IFRS 10)
Associate	An associate is an entity over which the investor has significant influence, but does not control. (IAS28)	Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control of those policies. We can assume that significant influence exists if the percentage holding is greater than or equal to 20% of the ordinary shares. The standard also says that the existence of significant influence by an entity is usually evidenced in one or more of the following ways: • Representation on the board of directors; • Participation in the policy-making process; • Material transactions between the entity and investee; • Interchange of managerial personnel; • Provision of essential technical information.

If neither of these criteria are met, the asset will be treated as an investment if it is a business; if it is not a business it will be treated as a group of assets. We will discuss

these classifications under business combinations, below. Note that the two categories of control have their own standards. You need to remember the requirements of all the standards specifically to apply them correctly in the exam.

1.1.1 Identifying Control

The question of how to identify the degree of control that one entity holds over another is answered in IFRS 10. The standard establishes what it refers to as a control model, which is based on the existence of three elements of control. When all of these three elements of control are present, an investor is considered to control an investee and consolidation is required. When one or more of the elements is not present, an investor will not consolidate but instead be required to determine the nature of its relationship with the investee (e.g. significant influence, joint control) and apply the appropriate accounting under the requisite standards set out above.

To apply the control model, several initial steps are necessary before the assessment of whether each of the three elements of control are present. These steps are:

- Identify the investee
- Understand the purpose and design of the investee
- Identify the relevant activities of the investee and how decisions about these relevant activities are made

Relevant activities are the activities of the investee that significantly affect the investee's returns, the key issue to understand when applying the model is who exercises decision making power in different contexts. Examples of activities that, depending on the circumstances, can be relevant activities include:

- Selling and purchasing of goods or services;
- Managing financial assets during their life (including on default);
- Selecting, acquiring or disposing of assets;
- Researching and developing new products or processes; and
- Determining a funding structure or obtaining funding.

Examples of decisions made about relevant activities include:

- Establishing operating and capital budgets;
- Appointing, remunerating and terminating an investee's key management (e.g., CEO, COO, CFO) or service providers.

One factor to consider when assessing control is the extent to which shareholders are dispersed, organised, active or passive. If a company owns 10% of a publicly traded company's shares, and the remaining 90% are held by small individual investors, the company holding 10% is likely to exert significant influence, at least.

Once this contextual information has been gathered and assessed, the model can be applied to assess whether the investor does exercise significant control or not. 1.1.2 Applying the control model

IFRS 10 explains the application of the model as follows:

An investor controls an investee if and only if the investor has **all of the following** elements:

- Power over the investee, i.e. The investor has existing rights that give it the ability to

direct the relevant activities (the activities that **significantly affect the investee's returns**)

- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power over the investee to **affect the amount of the investor's returns**.

Power arises from rights, and such rights can be either straightforward (e.g. through voting rights) or be complex (e.g. embedded in contractual arrangements). An investor that holds only protective rights cannot have power over an investee and so cannot control an investee.

Protective rights differ from substantive rights. A right is substantive when the holder of that right has the practical ability to exercise that right. 'Protective rights' is defined as 'Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate. **A normal shareholder has substantive rights**, in theory at least, due to their right to a vote at the AGM. A bank lien on an asset on the other hand, is a protective right as it merely stops you from selling or borrowing against the asset until the associated liability is discharged.

An investor must be exposed, or have rights, to variable returns from its involvement with an investee to control the investee. Such returns must have the potential to vary as a result of the investee's performance and can be positive, negative, or both.

A parent must not only have power over an investee and exposure or rights to variable returns from its involvement with the investee, but a parent must also have the ability to use its power over the investee to affect its returns from its involvement with the investee. This suggests that the parent is able to influence business strategy or operations directly, as well as influence the value and frequency of dividends, usually through having voting representation on the investee's board.

IFRS 10 states that a parent prepares consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

1.1.3 Control in IPSAS

The key differences between IPSAS and IFRS in respect of control arise from the frequent absence of contractual arrangements in the establishment of economic entities in the public sector. It is important to understand that the usual assumption about each accounting entity having legal standing through incorporation does not always apply in the public sector, where ministries, for Example, are not typically legal persons (despite being able to enter into contracts with private sector companies). So, as we have seen throughout this workbook, when considering IPSAS the main issue is often terminology, as opposed to there being significant differences in accounting treatment. According to IPSAS 35 *Consolidated Financial Statements*, the definition of control is as follows:

Control: An entity controls another entity when the entity is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature or amount of those benefits through its power over the other entity.

You should note that there is no reference to investment in this definition, and the rights here are to variable benefits, rather than to the investee's returns. These differences reflect the fact that public sector entities are often not investments but service delivery vehicles, as you are aware.

1.1.4 Exceptions to IFRS 10

A parent need not present consolidated financial statements if it meets **all of the following conditions**:

- It is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements
- Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)
- It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and
- Its ultimate or any intermediate parent of the parent produces financial statements available for public use that comply with IFRS 10, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with that standard

The key point to understand is that under IFRS every company must report consistently, and in certain cases disclosure by the parent applying IFRS 10 can obviate the need for the subsidiary to consolidate its own controlled entities. Publicly traded companies, however, and issuers of public debt, are never exempt from IFRS 10.

In addition, post-employment benefit plans or other long-term employee benefit plans to which IAS 19 *Employee Benefits* applies are not required to apply IFRS 10.

Investment entities are treated differently to other types of entities and do not consolidate their subsidiaries, or apply IFRS 3 Business Combinations when they obtain control of another entity. Instead, investment entities are required to measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9 and IFRS 7, to reflect the nature of the purpose for which they are held. Investment entities are still required to consolidate a subsidiary, however, where that subsidiary provides services that relate to the investment entity's investment activities.

1.2 Business Combinations

Financial Reporting refers briefly to IFRS 3 *Business Combinations* in the context of recognising contingent assets and liabilities and intangibles, when a business is acquired. But it did not discuss the application requirements of the standard, or what its purpose is, more broadly. IFRS 3 provides guidance on how to classify a business acquisition at the most basic level, which is to determine whether the entity acquired actually constitutes a business at all. Furthermore, it assists companies in properly reflecting the impact of any non-controlling interest, and the extent of goodwill acquired. Finally, it provides disclosure guidance to help users understand the impact of the business combination.

IFRS 3 defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses.

A **business** is defined as:

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

IFRS 3 must be applied when accounting for business combinations, but does not apply to:

- The formation of a joint venture (which has its own standard)
- The acquisition of an asset or group of assets that is not a business (guidance provided in IFRS 3)
- Combinations of entities or businesses under common control (the IASB has a separate agenda project on common control transactions)
- Acquisitions by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss under IFRS 10 (investment entities follow different rules)

1.2.1 Determining whether a transaction is a business combination

IFRS 3 provides additional guidance on determining whether a transaction meets the definition of a business combination, and so accounted for in accordance with its requirements. This guidance includes:

- Business combinations can occur in various ways, such as by transferring cash, incurring liabilities, issuing equity instruments (or any combination thereof), or by not issuing consideration at all (i.e. by contract alone)
- Business combinations can be structured in various ways to satisfy legal, taxation or other objectives, including one entity becoming a subsidiary of another, the transfer of net assets from one entity to another or to a new entity
- The business combination must involve the acquisition of a business, which generally has three elements:
    - ***Inputs –*** an economic resource (e.g. non-current assets, intellectual property) that creates outputs when one or more processes are applied to it.
    - ***Process –*** a system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs (e.g. strategic management, operational processes, resource management).
    - ***Output –*** the result of inputs and processes applied to those inputs.

In other words, the consideration transferred is not significant to the recognition criteria, what matters is that the acquired entity has a complete production cycle, whether that cycle produces physical products, financial income, or intellectual property. Note that it does not have to sell its products to constitute a business, because many companies exist within vertically integrated supply chains solely to produce output for the benefit of an a commonly owned company elsewhere in the supply chain.

Any acquisition which does not have a production cycle thus constitutes the acquisition of an asset and is accounted for in accordance with the relevant standard, depending on the nature of the asset or assets acquired.

In many cases, a business combination will result in changes to the acquired business's assets and liabilities which arise from the impact of commitments made by the previous owners becoming void due to the transfer in ownership. For Example, provisions established for restructuring may no longer be required under the new owners. 1.3 Recognition and Measurement under IFRS 3

IFRS 3 establishes the following principles in relation to the recognition and measurement

of items arising in a business combination:

- **Recognition principle**. Identifiable assets acquired, liabilities assumed, and non-controlling interests in the acquiree, are recognised separately from goodwill.
- **Measurement principle**. All assets acquired and liabilities assumed in a business combination are measured at acquisition-date fair value.

Assets are separated from goodwill and the two are recognised alongside liabilities and any non-controlling interest, and they are all measured on acquisition at fair value.

Non-controlling interest (NCI) is defined as any existing interest in a subsidiary that is not directly or indirectly attributable to a parent.

The exceptions noted in Financial Reporting which relate to contingencies and intangible assets should be applied when recognising the assets and liabilities arising from a business combination. They have been reproduced in the table below:

Under IFRS 3, the general recognition principle is that the identifiable assets acquired and liabilities assumed should meet the definition of assets and liabilities in accordance with the Conceptual. Framework at the acquisition date. However, some recognition and measurement exceptions have been included for particular types of assets and liabilities.	
Contingent liability	For a provision or contingent liability that would be within the scope of IAS 37, the acquirer applies IAS 37 to determine whether at the acquisition date a present obligation exists as a result of past events. A contingent liability assumed in a business combination is recognised at the acquisition date: • *only if* it is a present obligation that arises from past events and its fair value can be measured reliably, and • *even if* an outflow of economic benefits is not probable (uncertainty is considered in the determination of fair value). Other contingent liabilities are not recognised.
Contingent asset	Contingent assets at acquisition are not recognised.
Intangible assets	The acquirer may recognise identifiable intangible assets that are acquired in a business combination (e.g. a brand name, a patent or a customer relationship), that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

The key point to appreciate is that obligations and claims that the acquired company recognised may not transfer to the new owners. The interesting items are contingent and intangible assets, the former being never recognised and the latter recognising what were, prior to the combination, internally developed assets that are not permitted under IAS 38.

In addition to these exceptions, other assets and liabilities assumed following a business combination should be recognised and measured in accordance with the relevant

standards, where applicable:

- Income taxes – the recognition and measurement of income taxes is in accordance with IAS 12.Employee benefits – assets and liabilities arising from an acquiree's employee benefits. arrangements are recognised and measured in accordance with IAS 19.
- Share-based payment transactions are measured by reference to the method in IFRS 2.
- Non-current Assets Held for Sale and Discontinued Operations are recognised and measured in accordance with IFRS 5.

1.3.1 Goodwill

The IFRS 3 recognition principal requires the separation of goodwill from other assets and liabilities because goodwill, as you are aware, is an accounting balance representing the difference in value between what was acquired and the consideration paid, and hence it has no fair value in itself (although its components are measured at fair value, as we will discuss below).

Goodwill is measured under IFRS 3 as the difference between:

- the aggregate of:
  - the value of the consideration transferred (generally at fair value),
  - the amount of any NCI, and
  - in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree, and
- at the acquisition date, the net amounts of the identifiable assets acquired and the liabilities assumed

This can be expressed as a formula:

Goodwill	=	Consideration	+	NCI	+	FV of previous equity interest	-	Net assets recognised

If the difference arising from the calculation of goodwill is negative, the resulting gain is a bargain purchase in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion. However, before any bargain purchase gain is recognised in profit or loss, the acquirer is required to undertake a review to ensure the identification of assets and liabilities is complete, and that measurements appropriately reflects consideration of all available information.

1.3.2 Contingent Considerations

IFRS 3 defines contingent consideration as: 'Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met' (this would be an asset).

The amount of this consideration can be significant and will usually depend on the subsequent performance of the entity acquired. The terms under which this consideration will be calculated and paid are set out in the acquisition agreement, and the contingent consideration is only paid if specified future events occur or conditions are met. Contingent considerations will typically comprise either equity or financial instruments, for Example, options to acquire shares in the combined entity if agreed performance targets are met, or to receive payment.

A contingent consideration must be measured at fair value at the time of the business combination and is included in the determination of goodwill. Due to the uncertain nature of the consideration, establishing its fair value can be difficult, and there is a legitimate question about whether the requirement for a transaction to take place at arm's length is applicable.

In terms of subsequent measurement, if the amount of a contingent consideration changes as a result of a post-acquisition event (such as meeting an earnings target), the accounting depends on whether the additional consideration is classified as an equity instrument or an asset or liability:

- If the contingent consideration is classified as an equity instrument, the original amount is not remeasured. When settled, the transaction will be accounted for through equity (e.g. Cr: Share Capital, Dr: Retained Earnings).
- If the additional consideration is classified as an asset or liability that is a financial instrument, the contingent consideration is measured at fair value and gains and losses are recognised in either profit or loss or other comprehensive income in accordance with IFRS 9.
- If the additional consideration is not within the scope of IFRS 9, it is accounted for in accordance with IAS 37 (i.e. as a provision or contingency) or other IFRSs as appropriate.

1.3.3 Non-controlling interest

The recognition of the non-controlling interest (NCI) is what permits us to consolidate 100% of a controlled company's assets, liabilities, revenue and expenditure, as it apportions the appropriate percentage of the, net periodic financial results in the profit or loss and OCI, to the NCI based on the degree of ownership. IFRS 3 permits two options in the initial recognition and measurement of the NCI. The parent measures any non-controlling interest either:

i). At fair value as determined by the directors of the acquiring company, or;

ii). At the non-controlling interest's proportionate share of the subsidiary's identifiable net assets.

The difference between the two methods is that (I) recognises the whole of the goodwill attributable to an acquired subsidiary (i.e. full goodwill method), whereas (II) only recognises the parent's share of the goodwill (i.e. partial goodwill method).

The choice in accounting policy applies only to present ownership interests in the acquiree that entitle holders to a proportionate share of the entity's net assets in the event of a liquidation (e.g. ordinary shares). Other components of non-controlling interests must be measured at acquisition date fair values or in accordance with other applicable IFRS.

The main reason a company would choose one option over the other relates to the financial reporting needs of their users. The proportionate share of the net assets option

reduces the value of goodwill recognised, but thereby maintains higher return on assets/equity ratios, whereas the non-proportionate option (NCIs measured at their fair value) increases assets and equity, but correspondingly reduces the associated ratios.

1.4 Preparing Consolidated Financial Statements

So far, this Unit has discussed consolidation in the context of business combinations, and there are as we have seen a number of issues to be specifically addressed when a new business is acquired, particularly the valuation of assets and liabilities. However, the consolidation process needs to also include subsidiaries and associates that are already recognised, and you will be expected in the exam to be able to answer questions where the consolidating entity includes a mix of existing and newly acquired subsidiaries and associates. This section of the Unit builds directly on the material covered in Financial Reporting, so we will recap the key contents for the statements of financial position and performance, before we turn to new material on preparation of the Statement of Cash Flows. It should be noted that the consolidation process assumes that the consolidating entity has access to the financial statements of the group entities and uses that information as the basis for the consolidation. This can be an issue due to the need to prepare the consolidated statements within regulatory reporting deadlines, and often requires companies to consolidate based on unaudited figures, which can result in subsequent adjustments.

As you have learned, the consolidation process is significantly more complex for subsidiaries than for associates, where the equity method is applied and only investment related entries are recorded in the parent's financial statements. However, the latter still requires the elimination of intra group profits and losses proportionate to the controlling interest. We will discuss associates in more detail, below.

IFRS 10 sets out the main procedures to follow when consolidating financial statements:

- **Combine** like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
- **Offset** (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary and apply IFRS 3 to account for any related goodwill.
- **Eliminate** in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (including profits resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full). Note that unrealised losses are not adjusted for in the consolidation process.

A reporting entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the reporting entity ceases to control the subsidiary.

The parent and subsidiaries are required by IFRS 10 to have the same reporting dates. The consolidated financial statements are prepared using the parent's reporting date. If the reporting date of the parent is different from that of the subsidiary, then consolidation is based on additional financial information prepared by the subsidiary (e.g. management accounts for the period outside the date of the consolidated financial statements), unless impracticable. Where impracticable, the most recent financial statements of the subsidiary are used, adjusted for the effects of significant transactions or events between the reporting dates of the subsidiary and consolidated financial statements.

The difference between the date of the subsidiary's financial statements and that of the consolidated financial statements should be no more than three months.

The key aspects of the process in respect of the consolidated financial statements can be summarised as follows:

- Subsidiaries are consolidated on a line-by-line basis for all elements of the financial statements.
- Entries which correspond to equity holdings and investments within the group need to be eliminated.
- Any amounts recognised in the individual financial statements of group entities arising from transactions within the group need to also be eliminated.
- Adjustments must be made for part year results in respect of acquisitions, disposals and different year ends.

1.4.1 Statement of Financial Position

As you learned in Financial Reporting, the preparation of the consolidated statement of financial position follows six steps. An extract from the workbook is provided below:

> We will look at the preparation of the statement of financial position and the statement of profit or loss separately, as there are some specific aspects that are best looked at in the context of each statement.
>
> In both cases, we will use a methodical process, involving a series of "steps". Although this process is not essential for simple Examples, it is important to use it consistently so that you make sure you deal with all aspects of the process.
>
> In dealing with Examples of consolidated statements of financial position, we will use the following six steps. Additional adjustments will need to be included within the relevant step(s), which we will add later in this unit.
>
> Step 1 Establish the group structure
>
> Step 2 Set out the net assets of the subsidiary
>
> Step 3 Calculate goodwill on acquisition
>
> Step 4 Calculate the non-controlling interest
>
> Step 5 Calculate group retained earnings
>
> Step 6 Prepare consolidated statement of financial position

Most of the Examples in Financial Reporting related to acquisitions, where all six steps need to be applied in sequence. Where a consolidating entity is reporting on its existing group it will still need to go through all six steps wherever the degree of its control over grouped entities may be subject to change. The assessment will include any publicly traded companies recognised, and ones where a non-controlling interest exists at the reporting date.

We have discussed the process for establishing the group structure above, by applying the IFRS 10 control model. The second step is to establish the net assets of the subsidiary.

Assets and Liabilities

When preparing a consolidated statement of financial position, the assets and liabilities of the parent and the subsidiary are added together and then subject to consolidation adjustments. For Example, as the objective of the exercise is to prepare the consolidated statement of financial position as if the group were a single entity, it is necessary to eliminate the balances on any intra-group current accounts as the group should only be reporting assets and liabilities external to the group. All receivables and payables relating to members of the group should thus be eliminated on consolidation. Financial Reporting included the following summary table:

Where group companies trade with each other, there are several ways in which balances with each other can arise. The most common of these are listed below:	
Debentures/Loan stock	Where one company in the group has made a loan to another – in one company there is a payable and in the other there is a receivable (normally shown as investment). These are cancelled on consolidation. The cancellation process is very simple: the credit balance of one company is offset against the debit balance of the other company, eliminating both balances from the consolidated statement of financial position. We only include debentures/loan stock held by third parties in the consolidated statement of financial position.
Inter-company accounts	These are intra-group trading balances, e.g. current assets of subsidiary might include amounts owing from parent. These amounts will be included as current liabilities by the parent. It can also be the vice-versa case where the parent has a current asset (receivable from the subsidiary) while the subsidiary has a current liability (payable to the parent). The treatment of inter-company account balances is the same as for debentures/ loan stock. Inter-company accounts may not agree due to goods in transit or cash in transit. If the difference is cash in transit, increase the consolidated cash balance by that amount. If the difference is goods in transit, increase the consolidated inventory by that amount. Thereafter, eliminate the reconciled inter-company asset and liability as noted above.
Bank balances	Bank overdrafts (liability) and cash at bank (asset) must be shown separately. It is not permissible to offset bank overdrafts against cash at bank.

Unrealised profit in inventory	Group companies often sell goods (or any other assets) to one another. Transfers may include an element of profit. If goods or assets are subsequently sold, the group has realised the profit and no further adjustment is necessary. However, if goods or assets are still held within the group at the year end, we need to remove any unrealised profit. In consolidated accounts, we want to reflect only profits made by group companies trading with third parties. The exact adjustments depend on whether Parent (P) sold to Subsidiary (S) or Subsidiary (S) sold to Parent (P).
Parent sells to Subsidiary	Profit in inventory arising when P sells to S is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from P's retained earnings at the reporting date. Debit P's retained earnings (in Step 5). Credit Closing inventory (in consolidated statement of financial position).
Subsidiary sells to Parent	Profit in inventory arising when S sells to P is not realised outside the group. This profit must be calculated and removed from inventory at the reporting date and also from S's retained earnings at the reporting date. Debit S's retained earnings (in Step 2 – reporting date column) Credit Closing inventory (in consolidated statement of financial position) Allocate a share of the calculated unrealised profits to the NCIs (based on the NCIs' percent shareholding in the subsidiary)
Calculation of the unrealised profits	Unrealised profit is calculated using one of the three methods below; depending on the information you are given in the question: **a) Gross profit margin given:** Example: P sold goods to S for FRW 10 million. The profit margin was 40%. At the year end, S had sold half of these goods on to a third party. Unrealised profit = Inventory value X % margin/100% Inventory = half of 10 million = 5 million Unrealised profits = 5 million x 40%/100% = 2 million

	b) Mark-up given Example: P makes sales of FRW 10 million to S. This figure comprises cost plus 25% mark-up. S had sold half of these goods to a third party at the year-end. Unrealised profit = Inventory value X % mark-up/ (100% + % mark-up) Inventory = half of 10 million = 5 million Unrealised profits = 5 million x 25/ (100%+25%) = 1 million **c) if a Profit figure is given** Unrealised profit = profit figure given X % of goods unsold.

Example - Statement of financial position

The following statements of financial position are for Companies E, X and Z, as at 31 March 20X5:

	E	**X**	**Z**
	Million	Million	Million
Tangible non-current assets	440	410	250
Investment – 60m shares in X	400	0	0
Investment – 55m shares in Z	160	0	0
Current assets	50	70	40
Total assets	**1050**	**480**	**290**
Share capital	200	100	100
Retained earnings	750	340	140
Current liabilities	100	40	50
Total equity and liabilities	**1050**	**480**	**290**

Company E acquired share capital in Company X on 30 June 20X3. At that date the retained earnings of X amounted to 300 million.
Since the acquisition impairment of goodwill acquired on Company X totalling 15 million has been recognised.
Company X acquired share capital in Company Z on 31 March 20X4, at that date the retained earnings of Z amounted to 120 million.

During the year, Company E sold material for 30 million to Company X, recording a profit of 12 million in its individual financial statements.
At the reporting date 50% of the material remains in Company X's inventory.

Prepare a consolidated statement of financial position as at 31 March 20X5 for Company E.

Solution

Step 1. Establish the group structure

E owns 60% of X (60m of the 100m recorded as X's share capital)

Non-controlling interest = 40%

E owns 55% of Z, NCI therefore = 45%

We can assume in the absence of any contrary information, that Company E controls Company X and Z will thus consolidate it as a subsidiary.

Step 2 Set out the net assets of the subsidiary

In this step we calculate the net assets of the subsidiary in order to use these figures in subsequent calculations.

Company X		
	20X3 (Acquisition date)	**20X5 (Reporting date)**
	Million	Million
Share capital	100	100
Retained earnings	300	340
Total	**400**	**440**
Company Z		
	20X4 (Acquisition date)	**20X5 (Reporting date)**
	Million	Million
Share capital	100	100
Retained earnings	120	140
Total	**220**	**240**

Step 3. Calculate goodwill on acquisition

This calculation only needs to be performed when additional ownership claims such as shares are acquired, but goodwill still needs to be assessed for impairment at each reporting date.

	Company X		Company Z
	Million		Million
Cost of shares acquired	400		160
Less: share of net assets at acquisition			
(60% × 400)	-240	*(55% x 220)*	-121
Goodwill (before impairment)	160		39
Less: Impairment to date	-15		0
Goodwill	**145**		**39**

Step 4 Calculate the non-controlling interest

The value of the non-controlling interest to be included in equity is their share of X's and Z's net assets at 31 March 20X5 =	
Company X: 40% × (440 - 6) unrealised profit - see Step 5 below =	174
Company Z: 45% x 240 =	108
Total NCI =	**282**

Step 5 Calculate group retained earnings

In this calculation, we need to add E's claim on the retained earnings of X and Z and to E's own balance. We do this by calculating the movement in retained earnings since acquisition and adjusting this for the non-controlling interest, as well as any impairments. In this case goodwill needs to be impaired by 15.

We also need to make any necessary adjustments to retained earnings to eliminate intra group balances. In this scenario we are informed about unsold inventory, the profit on which needs to be adjusted.

Company X	Million
Adjustment for profit on unsold inventory	
Current assets 20X5	70
Less: 12 million x 50%	-6
Total Current Assets	**64**

Company E	
Adjustment for profit on unsold inventory	
Retained earnings 20X5	750
Less: 12 million x 50%	-6
Total Retained Earnings	**744**

Now we can use the adjusted retained earnings balance to calculate the group total.

	Million	Million
Parent's retained earnings (100%)		**744**
Company X - group share of post-acquisition retained earnings:		
Retained earnings 20X5	340	
Less: retained earnings 20X3	-300	
Post-acquisition retained earnings	40	
Group share = 60% × 40		23
Goodwill impairment		-15
Total Retained Earnings		**8**
Company Z - group share of post-acquisition retained earnings:		
Retained earnings 20X5	140	
Less: retained earnings 20X4	-120	
Post-acquisition retained earnings	20	
Group share = 55% × 20		11
Goodwill impairment		0
Total Retained Earnings		**11**

Group retained earnings		**763**

Step 6

Company E – Consolidated statement of financial position at 31 March 20X5:		
		Million
Tangible non-current assets	E + X + Z = 440 + 410 + 250	1100
Goodwill	*Step 3*	184
Current assets	E + X + Z = 44 + 70 - 6 + 40	148
Total assets		**1432**
Share capital	E only	200
Retained earnings	*Step 5*	763
Non-controlling interest	*Step 4*	282
Current liabilities	E + X + Z = 100 + 40 + 50	190
Total equity and liabilities		**1432**

You should have noted that adding an extra subsidiary presents no real difficulty as the process is identical for both. However, the additional calculations may be time consuming in the exam and it is therefore critical for you to learn the consolidation process by heart, so that you do each step correctly in the right order and not waste any time. You will have to prepare consolidated financial statements in one form or the other during the exam.

1.4.2 Profit and Loss

You learned the six steps required to prepare the consolidated statement of financial performance in Financial Reporting, and the relevant extract is set out below:

> In dealing with Examples of consolidated statements of profit or loss, we will use the following six steps. Additional adjustments will need to be included within the relevant step(s).

Step 1	Establish the group structure
Step 2	Adjust for unrealised profits
Step 3	Calculate revenue and cost of sales
Step 4	Calculate intra-group investment income and interest payable
Step 5	Calculate non-controlling interest
Step 6	Prepare consolidated statement of profit or loss

The concepts underlying group accounts apply to the statement of profit or loss and income and expenses are consolidated 100% line by line.

This concept would also apply to other comprehensive income when the parents and the subsidiaries are consolidated by adding 100% line by line.

When preparing the consolidation, it is important to remember the concept of single entity and transactions between the parent and the subsidiary must be cancelled out.

The following adjustments may arise:

- Intra-group sales must be eliminated from both the revenue of the selling company and the cost of sales of the buying company – Dr: Revenue, Cr: Cost of sales.
- Unrealised profit included in year-end inventory must be eliminated – Dr: Cost of sales (Dr: Retained Earnings in SFP), Cr: Closing inventory.
- Any intra-group interest must be eliminated from finance income and finance costs – Dr: Finance Income, Cr: Finance Costs.
- Dividends from subsidiaries must be eliminated since the whole of the profits of those subsidiaries are being consolidated and it would be double counting to include the dividends as well – Dr: Dividends received, Cr: Bank and cash.

When preparing the consolidation, we will add in 100% of the income and expenses of the subsidiary to reflect control but then we need to show ownership by calculating the non- controlling interest. NCI is calculated as the NCI % × Subsidiary's profit after tax.

The allocation of the profit after tax of the subsidiary (between the parent shareholders and the NCI shareholders) is shown at the end of the consolidated statement of profit or loss.

This shows who owns the profits that have been earned under group control.

Profit for the year	**XX**
Attributable to:	
Equity shareholders in parent (balancing Figure)	X
Non-controlling interest (NCI% × Profit after tax)	X
Profit for the year	**XX**

Example – Statement of Profit or Loss

The following statements of profit or loss are for Company L, P and W for the year ended 31 December 20X5:

	L	P	W
	Millions	Millions	Millions
Revenue	900	700	500
Cost of sales	- 300	- 350	- 200
Gross profit	600	350	300
Distribution costs	- 60	- 90	- 80
Administrative expenses	- 140	- 110	- 90
Interest expense (payments from W)	-	-	- 30
Interest income (payments from P)	-	30	-
Investment income (dividend from P)	50	-	-
Profit before tax	450	180	100
Tax	- 135	- 54	- 30
Profit of the year	315	126	70

- L controls 70% of the ordinary share capital of P and 60% of the share capital of W.
- During the year, P sold goods to L for 50 million. These had cost P 30 million. At 31 December 20X5, P still had half of these goods in inventory.
- P has provided W with a loan paying an interest rate of 8%, during the year W paid 30 million to P as interest on the loan.

Prepare a consolidated statement of profit or loss for the year ending 31 December 20X5.

Solution

Step 1 Establish the group structure

L owns 70% of P

Non-controlling interest = 30%

L owns 60% of W

Non-controlling interest = 40%

Step 2 Unrealised profits

This step involves adjusting P's profit figure to remove the amount relating to inventory sold within the group and held at year end.

	Million
Goods transferred from P to L	50
Cost of goods transferred	(30)
Profit	20
Unrealised profit (50% × 20)	10

Step 3 Revenue and cost of sales

In this step we will adjust both figures for intra-group sales, and add back the unrealised profit in order to avoid counting it twice.

		Million
Revenue	- L	900
	- P	700
	- W	500
Total		2 100
Less: Intra-group sale		(50)
Consolidated revenue		2 050

Cost of sales	- L	300
	- P	350
	- W	200
Total		850

	Million
Less: Intra-group purchase	(50)
Add: Unrealised profit (step 2)	10
Consolidated cost of sales	810

Step 4

In this step we eliminate the interest income paid by W to P.

	Million
P - Interest Income	30
W- Interest Expense	(30)
Consolidated finance expense	-

Step 5 - Non-controlling interest

Here we adjust the profit for the year for both P and W to account for the unrealised profit and calculate the amount due to the NCI.

P	NCI = 30% × (126 – 10 – 30) =	26
W	NCI = 40% × (70 + 30) =	40

Step 6 – Consolidated statement

Company L – Consolidated Statement of profit or loss for the year ended 31 Dec 20X5.

	Workings		Million
Revenue	Step 3		2 050
Cost of sales	Step 3	-	810
Gross profit			1 240
Distribution costs	(60 + 90 + 80)	-	230
Admin expenses	(140 + 110 + 90)	-	340
Finance expense	(30 - 30)		-
Profit before tax			670
Taxation	(135 + 54 + 30)	-	219
Profit for the year			**451**
Attributable to:			
Equity shareholders in L	Balancing figure		385
Non-controlling interest	Step 5		66
Profit for the year			451

1.5 Statement of Cash Flows

You learned about the purpose, format and preparation of the statement of cash flows in Financial Reporting. The preparation of the consolidated statement of cash flows follows exactly the same process and principles, following the requirements of IAS 7 ***Statement of cash flows*** and IFRS 10 ***Consolidated Financial Statements***. In other words, removing intra group transactions and passing adjustments to equalise valuations and accounting policies. In the exam, you will be expected to prepare the consolidated cash flow statement for a group using the other consolidated financial statements, so the process is similar to adjusting for non-cash items on the single entity Statement of Cash Flows. However, these questions are likely to also include consolidation-specific cash flow adjustments such as dividends paid to Non-Controlling Interests or the cash implications of acquisitions and disposals within the group.

The following summary information from Financial Reporting is provided as a reminder. You should refer back to the workings shown in that workbook to refresh your knowledge of Statement of Cash Flowss:

The format of the statement of cash flows as prescribed by IAS 7 is as follows:

Statement of cash flows for the year ended...	
Cash flows from operating activities	X/(X)
Cash flows from investing activities	X/(X)
Cash flows from financing activities	X/(X)
Net increase/(decrease) in cash and cash equivalents	**X/(X)**
Cash and cash equivalents at beginning of period	X/(X)
Cash and cash equivalents at end of period	X/(X)

The net increase / decrease in cash and cash equivalents is equal to the movement between the opening and closing balances for cash and cash equivalents.

IAS 7 gives the following definitions:

Cash flows	Inflows and outflows of cash and cash equivalents.
Cash	Cash comprises cash on hand and demand deposit (includes overdrafts).
Cash equivalents	Short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value.
Operating activities	Principal revenue producing activities and other activities of the entity that are not investing or financing activities.

Investing activities	The acquisition and disposal of long-term assets and other investments not included in cash equivalents.
Financing activities	Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

The reporting of cash flows from operating activities can be done using either of the following methods:

- **The direct method**: major classes of gross cash receipts and gross cash payments and cash receipts from customers, and cash payments to suppliers are disclosed.
- **The indirect method:** profit or loss is adjusted for the effects of transactions of a noncash nature and the accrual or deferral of past or future operating cash receipts or payments e.g. profit adjusted for depreciation and any increase in trade payables and accruals.

1.5.1 Applying IAS 7

The process for applying IAS 7 requires two steps: first we need to obtain information about the cash flows that occurred during the reporting period; second, we need to classify the cash flows into one of the three categories available. The methods allowed to report cash flows involve different approaches: the direct method requires the presentation of actual cash flows, which essentially requires the presentation of the cash book, but following the IAS 7 format. This process is relatively laborious unless the accounting system is designed to generate a cash out-turn, as is the case with many governments. Companies will not normally use this method unless regulations require them to do so. The format for the direct method is shown below:

Proceeds recieved from cash sales (goods or services)	x
Cash recieved from customers	x
Other cash incomes	x
Payments made for cash purchases	(x)
Cash paid to suppliers for purchase of goods or services	(x)
Other expenses paid in cash	(x)
Any cash paid or received as a refund of income tax	(x)
Net cash flow from operating activities	x/(x)

The indirect method is easier, as it involves the adjustment of the accrual financial statements, to present figures which represent movements in balances and flows on the statement of profit and loss. This is the method that is tested in the exam, where you will prepare a Statement of Cash Flows based on the other statements. There are a few basic principles to apply when preparing a Statement of Cash Flows, which you learned about by following the steps laid out in Financial Reporting. A standard format for the indirect

method of cash flow preparation is shown below with some typical line items (which may not be identical to that presented in the exam):

Standard Format for Cash Flow Preparation

	Million
Cash flows from operating activities	
Profit before tax	X/(X)
Adjustment for non-cash items:	
Depreciation	X
Profit or loss on disposal	X/(X)
Adjustment for items not related to operating activities:	
Investment income	(X)
Interest payable (finance costs)	X
Adjustment for movements in working capital	
Movement in inventory	(X)/X
Movement in receivables	(X)/X
Movement in payables	X/(X)
Cash generated from operations	**X/(X)**
Interest paid	(X)
Tax paid	(X)
Net cash flows from operations	**X/(X)**
Cash flows from investing activities	
Purchase of non-current assets	(X)
Proceeds from sale of non-current assets	X/(X)
Interest received	X
Dividends received	X
Net cash flows from investing activities	**X/(X)**
Cash flows from financing activities	

	Million
Proceeds from issuing shares	X
Payments to redeem shares	(X)
Proceeds from issuing debentures and loans	X
Payments to redeem debentures and loans	(X)
Payment of lease principal	(X)
Dividends paid	(X)
Net cash flow from financing activities	**X/(X)**
Net increase/(decrease) in cash and cash equivalents	**X/(X)**
Cash and cash equivalents at beginning of period	X/(X)
Cash and cash equivalents at end of period	X/(X)

The key to understanding the signage of the Statement of Cash Flows is that a positive cash balance has positive signage, and anything which increases the supply of cash is also positive. Cash outflows from the business are negative, so receiving a payment from a customer is a positive cash flow, whereas paying a supplier is negative. Note how the movement on payables is signed X/(X) while the movement on receivables is signed (X)/X to reflect this presentation.

When reporting on cash flows in relation to working capital items included in current assets and liabilities, you apply the principle that anything which increases the supply of cash as a positive, and anything which decreases it as a negative. More inventory from one year to the next = less cash available; more payables, along with a reduction in receivables = more cash. The opposite applies: less payables relative to the prior year means more cash used, and more receivables means less cash collected.

When making adjustments for income and expenses relating to Statement of Financial Position items more generally you will calculate the cash portion by adding the amount shown in the profit and loss to the movement in the related balance between the prior and current year, always remembering that anything that increases the amount of cash available is a positive. This applies to PPE, tax, equity and other balances whose movements in the period involve a cash element. One of the primary issues in the application of IAS 7 is the classification of cash flows into the correct reporting activity. While this is relatively simple for many businesses, the definition of operational activities depends on the nature of those operations, and financial institutions trade and actively manage financial instruments as their primary source of revenue. Similarly, businesses which manage investment property, large landlords and property developers, actively trade in assets which most businesses would hold for capital management (investment) purposes. As an Example, an extract is provided below from the Equity Bank Rwanda PLC's

audited Statement of Cash Flows for 2022:

Statement of cashflows	31st Dec 2022 Frw '000'	31st Dec 2021 Frw '000'
Operating activities	34,788,168	17,849,609
Profit before income tax		
Adjustments for:		
Depreciation on property and equipment	1,011,588	1,039,056
Depreciation on right of use assets	840,166	862,854
Amortisation of intangible assets	114,713	93,227
Interest expense on lease liability	252,258	210,884
Profit/loss on disposal of property and equipment	11,505	26,577
Interest expense on term borrowings	2,725,654	2,850,087
Provision for impairment losses on loans and advances	4,513,168	6,403,787
Net foreign exchange gain on cash and cash equivalents	(13,606,2621)	(2,469.2171)
Operating profit before changes in operating assets and liabilities	**40,640,958**	**26,866,860**
Loans and advances	(25,197,7091)	(37,446,9711)
Other assets	1,487,984	(3,314,235)
Right of use assets	(1183,4181)	(2,067,6861)
Tax recoverable	696,499	-
Deposits from customers	121,960,411	85,191,002
Deposit from Banks	(110,809,8091)	3,805,853
Due from related party balances	(91,627)	(40,171)
Due to related party balances	296,076	292,260
Other liabilities	(583,079)	(1,634,8391)
Lease Liabilities	206,007	2,104,851
Deferred tax assets	(4,221,325)	586,877
Deferred tax liabilities	(61,457)	61,457

Statement of cashflows	31st Dec 2022 Frw '000'	31st Dec 2021 Frw '000'
Movement in restricted cash balances	(17.015,9361)	(5.155,8841)
Cash generated from operations	**117,123,575**	**69,249,354**
Income taxes paid	(15,790,959)	(17,745,2231)
Net cash from operating activities	**111,332,616**	**61,504,131**

Source: https://equitygroupholdings.com/rw/uploads/Equity-Bank-Rwanda-Financial-Statement-and-other-Disclosures-for-the-Year-ended-31st-December-2022.pdf

As you can see, along with standard adjustments for depreciation and movements in working capital, operational activities include many cash flows relating to its banking activities, items which a manufacturing company would report under finance or investment, depending on their normal flow.

One way of thinking about the difference between the categories is to think about the format of the profit and loss, because the Statement of Cash Flows uses the same essential layout. In other words, and except for working capital adjustments, operational adjustments tend to be positive to derecognise accrued expenses included in operations, or cost of sales. Investments tend to be inflows because the purpose of an investment is to use assets to generate positive cashflows (although their cash purchase is obviously an outflow) and will use the income figure recognised in that portion of the profit and loss. Financing, on the other hand, is about the liability side of the Statement of Financial Position and tends to involve outflows to service debt (again, recognition of a new liability may result in a positive cash flow), also from the lower portion of the profit and loss. Because preparing a Statement of Cash Flows involves so many steps it is critical that you are clear on the signage to apply in your calculations. While these assumptions are generally useful, exceptions are always likely to arise.

1.5.2 Preparing a Statement of Cash Flows

There are a series of steps that should be performed when preparing a statement of cash flows.

Step 1: Prepare—Gather Basic Documents and Data

To start, you need to obtain at least the following documents:

- A statement of financial position as at the end of the current reporting period and as at the beginning of the current reporting period
- A statement of comprehensive income for the current reporting period
- A statement of changes in equity for the current reporting period
- A statement of cash flows for the previous reporting period—well, you can proceed further without this, but it's good source of potential recurring adjustments in the current period
- Information about material transactions in the company during the current reporting period.

In the exam you will be provided with extracts from the statements necessary to complete the assigned task.

Step 2: Calculate Changes in the Statement of Financial Position

In this step you should prepare a table with four columns representing the Statement of Financial Position, using the line item in column 1, the closing/reporting balance in column 2, and the opening/prior year balance in column 3. Column 4 can then be used to compare the movement in balances – be careful to use the formula Opening balance – closing balance. This column can then be used to feed the calculations necessary to adjust for working capital and other movements in balances that have a cash element.

Step 3: Allocate each change in balance to the Statement of Cash Flows

This step involves the classification of each movement into the relevant portion of the Statement of Cash Flows, also adjusting for related cash flows reported on the statement of profit and loss. In each case you should take the opening balance, add it to the amount shown on the profit and loss, and minus the closing balance. It will be helpful to add a fifth column to your table in order to present your working clearly.

Step 4: Adjust for any other information provided

Other information includes such things as whether any finance leases have been entered into, or dividends declared. These will need to be specifically adjusted for in the Statement of Cash Flows. In the exam this information will be provided in the notes. The following Example will help refresh your understanding of Statement of Cash Flows preparation:

Example

Notes:

Company C is 100% owner of Company M, and holds 75% of the issued shares of Company R.

(a) Company C has declared dividends for the year ended 31 December 20X5 of 70 million.

(b) During 20X5 Company R declared its first ever dividend, totalling 12 million in respect of 20X4. This amount had been paid in full at year end.

(c) Depreciation charged in the year ended 31 December 20X5 was 27 million

(d) Assets with a book value of 100 million were disposed of during the year, and receipts from their sales amounted to 125 million.

(e) Some previously revalued PPE was impaired during the year ended 31 December 20X5.

(f) Trade receivables include interest receivable, as follows:

- 31 December 20X3 4 million
- 31 December 20X5 3 million

(g) Administrative costs include 150 million on salaries and wages. There are no accruals relating to these items.

Prepare the consolidated statement of cash flow for Company C for the year ended 31 December 20X5 using the indirect method.

Company C

Consolidated Statement of Financial Position as at 31 December:		
	20X5	**20X4**
	Million	Million
Non-current assets		
Property, plant and equipment	1 585	1 387
Goodwill	68	68
Current assets		
Inventories	365	332
Trade receivables	102	320
Dividends receivable	-	-
Investments	24	35
Cash and cash equivalents	-	-
Total assets	**2 144**	**2 142**
Equity and liabilities		
Share capital	1 030	1 000
Share premium	65	65
Revaluation reserve	60	90
Retained earnings	450	283
Non Controlling Interest	68	48
Non-current liabilities		
Long-term borrowings	157	129
Current liabilities		
Trade payables	159	237
Tax payable	30	41
Interest payable	7	4

Dividends (ordinary)	5	15
Bank overdraft	113	230
Total equity and liabilities	**2 144**	**2 142**

Consolidated Statement of Profit or Loss for year ended 31 December 20X5	
	Million
Revenue	2 625
Cost of sales	- 1 721
Gross profit	**904**
Distribution costs	- 260
Administrative expenses	- 175
Operating profit	**469**
Interest income	17
Finance costs	- 35
Profit before tax	**451**
Income tax	- 135
Profit after tax	**316**

Consolidated Statement of Cash Flows for year ended 31 December 20X5	
	Million
Cash flows from operating activities	
Profit before tax	451
Adjustment for non-cash items:	
Depreciation	27
Profit on disposal (125 – 100)	- 25
Investment income	- 17

Interest payable (finance costs)	35
Increase in inventory (-)	- 33
Decrease in receivables (+)	218
Decrease in payables (-)	- 78
Cash generated from operations	**578**
Interest paid (35 + 4 – 7)	- 32
Tax paid (172 + 41 – 30)	- 146
Net cash flows from operations	**400**
Cash flows from investing activities	
Purchase of non-current assets (W1)	- 355
Proceeds from sale of non-current assets	125
Interest received (17 + 4 – 3)	18
Dividends received (W2)	9
Net cash flows from investing activities	**- 203**
Cash flows from financing activities	
Dividends paid to Company C Shareholders (W2)	- 80
Dividends paid to NCI (W2)	- 3
Net cash flow from financing activities	**- 80**
Net increase/(decrease) in cash and cash equivalents	**117**
Cash and cash equivalents at beginning of period	- 230
Cash and cash equivalents at end of period	- 113

(W1) PPE	

Opening balance	1 387
Depreciation	- 27
Disposal	- 100
Revaluation change	- 30
Closing balance	- 1 585
(W2) Dividends	
	R
Dividends paid	12
Group @ 60%	9
NCI @ 40%	3
	M
Opening Balance	15
Declared	70
Closing Balance	5
Paid in Year	80

1.6 Disclosures

The disclosure requirements for subsidiaries are not set out in IFRS 10, but in IFRS 12 *Disclosure of Interests in Other Entities*. This standard is a consolidated disclosure standard requiring a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated 'structured entities'. It should be noted that the requirements are stated in quite broad terms in order to ensure that the objectives of financial reporting are met, rather than prescribing highly specific requirements that may often not apply to specific companies or groups.

The requirements in respect of subsidiaries are as follows:

An entity shall disclose information that enables users of its consolidated financial statements to:

- Understand the composition of the group.
- Understand the interest that non-controlling interests have in the group's activities and cash flows.

- Evaluate the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group.
- Evaluate the nature of, and changes in, the risks associated with its interests in consolidated structured entities.
- Evaluate the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control.
- Evaluate the consequences of losing control of a subsidiary during the reporting period.

IFRS 12 itself provides considerable guidance to assist companies in understanding how to account for and report information that assists users in the areas specified.

E.2 Associates and joint arrangements

2.1 Introduction

In this section we will refresh your knowledge of associates and discuss how the relevant standard, IAS 28 *Investment in Associates and Joint Ventures* is applied to the treatment of an investment in an associate and an investment in a joint venture. The accounting treatment for the two is basically the same, but they have their own specific requirements that need to be considered.

The precise objective of IAS 28 is to prescribe the accounting for investments in associates and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

The definition of an associate is based on an entity having significant influence over another entity, which is not sufficient to have direct control over its operations.

IAS 28 provides the following definitions:

- **Associate:** An entity over which the investor has significant influence.
- **Significant influence:** The power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies. Usually benchmarked at having 20% or more of the voting rights of the investee.

IAS 28 includes these definitions with respect to joint arrangements:

- **Joint arrangement:** An arrangement of which two or more parties have joint control.
- **Joint control:** The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.
- **Joint venture:** A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.
- **Joint venturer:** A party to a joint venture that has joint control of that joint venture.

You need to think of control as operating on three levels to differentiate the degree of decision-making power that a reporting entity is able exert in respect of subsidiaries, associates and joint venture:

- **Associate:** 20% or more, up to approximately 49%
- **Subsidiary:** above 50%

- **Joint venture:** 50/50, or 25/25/25/25, or similar

The percentages are normally thought of in terms of voting rights (rather than the value of equity held), and you should remember the discussion of the complexities of establishing whether control is substantive when applying these thresholds.

2.2 Joint Ventures

Joint ventures are typically established by companies, within the same group or otherwise, that want to work together for a specific objective. They thus tend to be project or objective specific, which means their assets are often transferred from the venturer, and they are not necessarily established indefinitely. Hence the importance of the venturers having specific rights to the venture's net assets as part of the definition.

You should note that joint control requires that decisions relating to the entity to be made unanimously by the venturers. An entity in which the reporting party does not participate in unanimous decision making (e.g. a publicly owned company where decisions depend on majority vote) is not a joint venture to that party.

2.2.1 Joint ventures and joint operations

When defining joint arrangements, IAS 28 distinguishes between:

- Situations in which power is jointly shared, and
- Situations in which power is jointly shared, and the investor has a right to the arrangement's net assets.

This difference gives rise to two separate classifications: joint ventures, which include asset rights, and joint operations, which do not.

Judgement will be needed when an entity assesses whether a joint arrangement is a joint venture or a joint operation. The rights and obligations arising from the arrangement will be assessed by considering:

- The structure and legal form of the arrangement.
- The terms agreed by the parties or established by legislative or executive authority.
- Other facts and circumstances, the structure and legal form of the arrangement.

When assessing the structure and legal form of the arrangement it is necessary to determine if a separate vehicle exists.

To be a joint venture, the joint arrangement:

- Must be structured through a separate vehicle, and
- Gives the venturer rights to the net assets of the arrangement. The rights must be to the net assets rather than separate rights to the assets and obligations for the liabilities.

If the joint arrangement is not structured through a separate vehicle, then it is a joint operation. With joint operations, each party will use its own resources in carrying out the activities and will incur its own expenses and liabilities. Each party will also be responsible for raising its own finance.

The arrangement between the parties will describe the nature of activities and how the

parties intend to undertake those activities. It will set out how the revenues and expenses will be shared. If an asset is shared and operated together the arrangement will establish the parties' rights to the joint asset and how output or revenue from the asset and operating costs are shared among the parties.

The substance of a joint operation is that each party to it is essentially carrying on its own activities as a separate part of its own business, and there is no distinct reporting entity.

2.3 Equity method

In Financial Reporting you learned that classification as either an associate and a subsidiary is important, from the perspective of properly applying the conceptual framework, because associates are valued using the equity method:

The reason that this is so important is that the accounting for an associate is different compared to a subsidiary because the investor in an associate does not have control. The method for accounting for associates in consolidated financial statements is the equity method.

The equity method is a method of accounting whereby an investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. This means that the change in an associate's net assets to be included in the consolidated financial statements is equivalent to the parent's share of the associate's profit or loss for that period.

In the separate financial statements of the investor the investment will be shown at cost, but in the consolidated statement of financial position an extra line will be added within the non-current assets as shown below.

The amount to be shown under the non-current assets (i.e., "Investment in an associate") is calculated as follows:

Cost of investment	X
Plus: Investor's % (step 1) of associate's post-acquisition retained earnings	X
Less: Impairment loss	(X)
Investment in associate	X

An associate is not controlled by the investor and therefore we do not consolidate the assets and liabilities as this would be misleading to the user.

For the investment in an associate, we show the original investment that has been made, plus their share of post-acquisition profits.

To summarise, under the equity method of accounting:

- The investment is initially recorded at historical cost, and adjustments are made to the value based on the investor's percentage ownership in net income, loss, and dividend payouts.
- Net income of the investee company increases the investor's asset value on their Statement of Financial Position, while the investee's loss or dividend payout decreases

it.

- The investor also records their percentage of the investee's net income or loss on their Statement of Profit or Loss (as the corresponding accounting entry).

The equity method represents associates as investments in the investor's consolidated financial statements, and not as an operational component of the company, and is valued and disclosed accordingly.

2.3.1 Determining cost

As noted above, associates are valued under the equity method at cost and this cost subsumes any extra cost paid in excess of the FV of the investor's share of the net assets in the associate. A separate calculation of Goodwill is therefore not necessary. However, it is important to note that where the initial cost paid by the investor to acquire the associate is less than the investor's share of the net assets in the associate, then the difference will be a credited to the investor's Profit or Loss, essentially representing negative goodwill – the bargain purchase.

Subsequently, appropriate adjustments to the investor's share of the profits or losses after acquisition are made to account for additional depreciation or amortisation of the associate's depreciable or amortisable assets based on the excess of their fair values over their carrying amounts at the time the investment was acquired. This means that the values at acquisition are recorded and used for the purposes of determining subsequent asset carrying amounts by applying the appropriate depreciation or impairment charges, instead of using the asset values recorded in the associate's subsequent financial statements.

2.3.2 Subsequent asset transfers

IAS 28 explains how subsequent transfers of assets (not businesses) between the investor and investee are treated. In all transfers, the consideration paid for the assets is used to assess whether the current carrying value of the asset is impaired or not, though the subsequent treatment depends on who is transferring the assets to whom:

- Gains and losses resulting from 'upstream' and 'downstream' transactions involving assets that do not constitute a business, as defined in IFRS 3, between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture.
- 'Upstream' transactions are, for Example, sales of assets from an associate or a joint venture to the investor. The entity's share in the associate's or the joint venture's gains or losses resulting from these transactions is eliminated.
- 'Downstream' transactions are, for Example, sales or contributions of assets from the investor to its associate or its joint venture. When downstream transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed, or of an impairment loss of those assets, those losses shall be recognised in full by the investor.
- When upstream transactions provide evidence of a reduction in the net realisable value of the assets to be purchased or of an impairment loss of those assets, the investor shall recognise its share in those losses.

If the assets are transferred 'upstream', any gains or losses recognised on the transfer in the investee's financial statements is eliminated on consolidation, in proportion to the NCI. 'Upstream' transactions also require an assessment of impairment which will need to be adjusted for on consolidation, if any impairments are identified. 'Downstream' transactions similarly require an impairment assessment, but this will be recognised directly and in full in the investor's financial statements if any are identified.

The table below is a basic reminder of the difference between applying IFRS 10 to a subsidiary, and IAS 28 to an associate:

Consolidation of a controlled entity (acquisition accounting)	Consolidation of an associate (equity accounting)
Line-by-line consolidation: Each type of asset and liability in the controlling entity's and controlled entity's statement of financial positions are summed.	**No line-by-line consolidation:** Instead, one line is added to non- current assets – "investment in associates".
Goodwill: Goodwill is calculated and is presented in non-current assets.	**No goodwill.**
Non-controlling interest: Non-controlling interest is calculated and presented in equity.	**No non-controlling interest.**
Retained surplus: Economic entity retained earnings calculation.	**Retained earnings:** Economic entity retained earnings calculation – same approach.
Intra-entity balances elimination.	Intra-entity balances cannot be eliminated.

2.4 Impairments

The impairment indicators in IAS 36 apply to investments in associates. If impairment is indicated, the amount is calculated by using the method set out in IAS 36, in other words the investment's carrying amount is compared to its recoverable amount and the difference is recorded through the profit and loss and the investment's carrying value.

IAS 28 requires that the entire carrying amount of the investment is tested for impairment as a single asset, that is, goodwill is not tested separately. The recoverable amount of an investment in an associate is assessed for each individual associate (as in its own right, an investment in an associate is considered to be a cash-generating unit), unless the associate does not generate cash flows independently.

2.5 Disclosures

The following disclosures are required by IFRS 12:

- The nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the

other investors with joint control of, or significant influence over, joint arrangements and associates.

- The nature of, and changes in, the risks associated with its interests in joint ventures and associates.

E.3 Changes in group structures

3.1 Introduction

The economic entity approach applied by IFRS 10 treats all providers of equity capital as shareholders of the entity, even when they are not shareholders in the parent company. Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing or gaining control of the subsidiary are equity transactions (i.e. transactions between the owners of the subsidiary i.e., the parent shareholders and the NCI shareholders in their capacity as owners of the subsidiary). When the proportion of the equity held by non-controlling interest changes, the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary.

Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent. In other words, where there is a change in ownership, but control is retained, you need to adjust the non-controlling interest amount reported in the financial statements (i.e., in the Group equity) to reflect that change. As you will be using the new figure for reporting, you will pass the necessary adjustments while following the standard steps.

Example

On 1 January 20X5, Company R acquired 70% of the shares of Company P, a public limited company. The purchase consideration comprised cash of 360 million. The fair value of the identifiable net assets was 480 million and the fair value of the NCI in P was 210 million on 1 January 20X5. Goodwill was calculated at 90 million on acquisition. Company R acquired a further 10% interest from the NCIs in P on 31 December 20X5 for a cash consideration of 85 million. The carrying amount of the net assets of P was 535 million at 31 December 2008.

The net assets of P have increased by (535 – 480) m = 55m and therefore the NCI has increased by 30% of 55m = 16.5m. However, R has purchased an additional 10% of the shares and this is treated as a treasury transaction. There is no adjustment to goodwill on the further acquisition.

	Million
P NCI, 1 January 2008	210
Share of increase in net assets in post-acquisition period	16.5
Net assets, 31 December 2008	226.5
Transfer to equity of R(10/30 x 226.5)	(75.5)
Balance at 31 December 2008 – NCI	151

	Million
Fair value of consideration	85
Charge to NCI	(75.5)
Negative movement in equity	9.5

Company R has effectively purchased a further share of the NCI, with the premium paid for that share being charged to equity. The situation is comparable when a parent company sells part of its holding but retains control.

This can be illustrated by changing the previous scenario so that Company R disposes of a 10% interest to the NCIs in P on 31 December 20X5 for a cash consideration of 65m. The carrying amount of the net assets of P is 535 million at 31 December 20X5.

	Million
P net assets at 1 January 2008	480
Increase in net assets	55
Net assets at 31 December 2008	535
Fair value of consideration	65
Transfer to NCI (10% x (535 net assets + 90 goodwill))	-62.5
Positive movement in equity	2.5
P net assets at 1 January 2008	480

R has effectively sold 10% of the carrying amount of the net assets (including goodwill) of the subsidiary (62.5m) at 31 December 2008 for a consideration of 65 million, giving a profit of 2.5 million, which is taken to equity.

In case of a disposal of voting rights in a subsidiary which results in the parent losing control over the subsidiary, the parent:

- Derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
- Recognises any investment retained in the former subsidiary when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRS Accounting Standards. That retained interest is remeasured to "fair value" and the remeasured value is regarded as the fair value on initial recognition of a financial asset or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.
- Recognises the gain or loss associated with the loss of control attributable to the former controlling interest.

On 1 January 2008, Company L acquired a 90% interest in Company M, a public limited company, for a cash consideration of 80 million. M's identifiable net assets had a fair value of 74 million, and the NCI had a fair value of 6m. On 31 December 2008, L disposed of 65% of the equity of M (no other investor obtained control as a result of the disposal) when its identifiable net assets were 83 million.

Of the increase in net assets, 6 million had been reported in profit or loss, and 3m had been reported in comprehensive income. The sale proceeds were 65 million, and the remaining equity interest was fair valued at 25 million. After the disposal, M is classified as an associate in accordance with IAS 28, *Investments in Associates*. The gain recognised in profit or loss would be as follows:

	Million
Fair value of consideration	65
NCI	6.9
(6 + (10% x (83-74)))	
Fair value of residual interest to be recognised as an associate	25
Gain reported in comprehensive income	3
	99.9
Less net assets and goodwill derecognised:	
Net assets	-83
Goodwill (80 + 6 – 74)	-12

A subsidiary acquired exclusively with a view to dispose of it would be classed as an asset held for sale under IFRS 5 *Non-current assets held for sale and discontinued operations*. Applying the criteria of IFRS 5, an entity that is committed to a sale involving loss of control of a subsidiary that qualifies for held for sale classifies all of the assets and liabilities of that subsidiary as held for sale, even if the entity will retain a non-controlling interest in its former subsidiary after the sale. IAS 28 *Investment in Associate* includes the following requirements:

- An entity shall apply IFRS 5 to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale.
- Any retained portion of an investment in an associate or a joint venture that has not been classified as held for sale shall be accounted for using the equity method until disposal of the portion that is classified as held for sale takes place.
- After the disposal takes place, an entity shall account for any retained interest in the associate or joint venture as a financial asset in accordance with IFRS 9 *Financial Instruments* unless the retained interest continues to be an associate or a joint venture, in which case the entity uses the equity method.

E.4 International operations

4.1 Introduction

You learned about translating transactions and balances in foreign currency into the presentation currency of a reporting entity using IAS 21 The Effects of Changes in Foreign Exchange Rates, in Financial Reporting. You covered the two key accounting concepts when dealing with currencies:

- Money measurement – ie financial information only takes into account those items

that can be stated in monetary terms. By using a standard monetary measurement, the financial statements of different organisations can be compared.

- Stable monetary unit – ie it is assumed that the value of the currency unit (ie the FRW, US dollar, or other currency being used) is stable.

Financial Reporting summarised as follows:

- A foreign currency transaction should be recorded initially at the rate of exchange **at the date of the transaction.**
- At each subsequent reporting date, the foreign currency monetary amounts (eg cash held in a foreign currency account, or a receivable that will be in a foreign currency) should be reported using the exchange rate at the date of the transaction.

We will look at the application of IAS 21 in more detail here, so that you can appreciate how to account for amounts denoted in foreign currencies when consolidating subsidiaries and valuing associates.

To translate foreign denominated financial statements, it is important to understand that the rates applied are based on the element we are referring to and whether the figure is a comparator or otherwise. This is summarised in the following table:

Element	Period	Rate
Assets and Liabilities	Current period (20X5)	Closing rate (20X5)
	Comparative period (20X4)	Closing rate (20X4)
Equity	Current and comparative period	See below
Income and expenses	Current period (20X5)	Actual rates or average in 20X5
	Comparative period (20X4)	Actual rates or average in 20X4

In addition to the above, translating a foreign denominated statement of financial position will give rise to an imbalance which is recognised by creating an entry in equity for the CTD or Currency Translation Difference. This is a balancing figure which shows the difference from translating the financial statements into the presentation currency.

With regard to equity, IAS 21 does not provide explicit guidance on rates that should be applied, but it is consistent with other standards to treat shares held in a subsidiary, for Example, at the historical rate applicable at the date of acquisition by the parent, rather than the historical rate applicable when the share capital was issued.

More broadly, if the equity balances result from the transactions with shareholders (for Example, share premium), then it is appropriate to apply the historical rate consistently with the rate applied for the share capital. If, on the other hand, the equity balances result from income and expenses presented in OCI (e.g. revaluation surplus), then it is more appropriate to translate them at the rate at the transaction date.

Also note that intra-group receivables and payables are translated at the closing rate, as with any other assets or liabilities, since the group is exposed to potential gains or losses

when the asset or liability is settled.

Profit or loss items, intra-group sales or amounts relating to unrealised profits should be translated at the date of a transaction if practical. If not, then apply the average rates for the period.

If a subsidiary pays a dividend to its parent, then the parent records the dividend revenue at the rate applicable when the dividend was declared, not paid. The reason is that the parent needs to recognise the dividend income when the shareholders' right to receive it was established (which is the declaration date, not the payment date).

Example

A Rwandan parent acquired a Ugandan subsidiary on 3 January 20X5 when the subsidiary's retained earnings amounted to USHS 4,000. On 30 November 20X6, the Rwandan parent purchased goods from the Ugandan subsidiary for USHS 5,000. All the goods were sold by the year-end on 31 Dec 20X6 and the payable was unpaid.

The applicable exchange rates are as follows:	
3 January 20X5:	0.7800
30 November 20X6:	0.8525
31 December 20x6:	0.8562
Average in 20X6:	0.8188
Average in 20X5:	0.7261

The financial statements of the Ugandan subsidiary at 31 December 2016 are shown below:

Statement of Financial Position	
	USHS (m)
PPE	80 000
Inventory	23 000
Receivables	23 000
Cash	20 000
Total Assets	**146 000**
Share Capital	100 000
Retained Earnings	31 000
Bank loan	10 000

Statement of Profit or Loss	
	USHS (m)
Sales	135 000
Cost of Sales	- 110 000
Other expenses	- 7 000
Profit before Tax	*18 000*
Tax	- 3 000
Profit after Tax	**15 000**

Statement of Financial Position			Statement of Profit or Loss	
Payables	5 000			
Total Equity & Liabilities	**146 000**			

To translate the USHS figures, retained earnings have been analysed by the individual years when they were generated, because different rates should be applied based on their dates.

The acquisition date rate should be applied to the translation of pre-acquisition retained earnings, then the rate applicable in 20X5 for 20X5 should be applied to profits etc.

Note that no rate was applied for the 2016 profit presented in the statement of financial position under equity. The reason is that this figure is taken directly from the statement of profit or loss.

The statement of financial position translated to FRW:

	USHS	Rate		FRW
Property, plant and equipment	80 000	Closing	0.8562	68 496
Inventories	23 000	Closing	0.8562	19 693
Receivables – intragroup	5 000	Closing	0.8562	4 281
Receivables – other	18 000	Closing	0.8562	15 412
Cash	20 000	Closing	0.8562	17 124
Total assets	**146 000**			**125 006**
Share capital	100 000	Acquisition date	0.7800	78 000
Retained earnings – pre-acquisition	4 000	Acquisition date	0.7800	3 120
Profit 2015	12 000	From 2015 statements	0.7261	8 713
Profit 2016	15 000	From P/L statement	n/a	12 451
Currency translation difference (CTD)	n/a	Balancing figure	n/a	9 879
Bank loan	10 000	Closing	0.8562	8 562

	USHS	Rate		FRW
Trade payables	5 000	Closing	0.8562	4 281
Total equity and liabilities	**146 000**			**125 006**

The statement of profit or loss translated to FRW:

	USHS	Rate		FRW
Sales – other	130 000	Average 2016	0.8188	106 444
Sales – intragroup	5 000	Transaction date	0.8525	4 263
Cost of sales	-110 000	Average 2016	0.8188	-90 068
Other expenses	-7 000	Average 2016	0.8188	-5 732
Profit before tax	***18 000***	n/a		***14 907***
Tax	-3 000	Average 2016	0.8188	-2 456
Net profit	**15 000**	**n/a**		**12 451**

The intra-group transactions and balances were analysed separately to enable them to be adjusted for on consolidation, using amounts based on the most appropriate date of translation. In this instance there is no unsold inventory or unrealised profit to adjust for, but in a different scenario this would be done using the standard consolidation process, ensuring to use the translated values. Public sector combinations and group accounting

As is typical with IPSAS, the consolidation related standards are all drawn directly from the relevant IAS/IFRS Accounting standards and apply the same method with some differences in application and terminology. The main differences between IFRS 10 *Consolidated Financial Statements* and IPSAS 35 *Consolidated Financial Statements* are set out at the back of the latter standard as follows:

- IPSAS 35 uses different terminology, in certain instances, from IFRS 10. The most significant Examples are the use of the terms "economic entity," "controlling entity," and "controlled entity". The equivalent terms in IFRS 10 are "group," "parent," and "subsidiary." In many cases the terms "investor" and "investee" used in IFRS 10 are replaced by references to "an entity", "another entity" or "an entity being assessed for control".
- IPSAS 35 defines the term "binding arrangement". This term is broader than the term "contractual arrangement", which is used in IFRS 10.
- IFRS 10 identifies typical characteristics of an investment entity separately from the definition of an investment entity. IPSAS 35 does not identify such typical characteristics. However, it does discuss some of these characteristics in the context of the definition of an investment entity.
- IPSAS 35 contains more guidance on non-financial benefits.
- IPSAS 35 contains additional illustrative Examples that reflect the public sector context. 4.2 Amalgamation and Acquisition

When we looked at business combinations earlier in this workbook, we assumed that in every combination one entity gains control over another one, in other words one company acquires another. This is not always the case in the public sector, where a change of government, for Example, might give rise to a reorganisation of ministries, which results in the transfer of assets and liabilities and perhaps the creation of new reporting entities. An amalgamation is a public sector combination in which no party gains control of one or more operations or if one party does gain control, the substance of the combination is that of an amalgamation.

There is a conceptual basis for distinguishing between acquisition and amalgamation accounting. Acquisitions involve one entity taking over another entity and are fairly common in the private sector. The core concept is for the acquirer to fair value all identifiable assets and liabilities of the purchased entity and to recognise goodwill if the amounts paid for an entity are more than the fair value of the assets and liabilities.

An amalgamation, however, implies "business as usual," the combined entity is fundamentally the same in both resources and service commitments and the financial statements should reflect the fact that the combination is a continuation, albeit with a different organisational structure. This means that the newly amalgamated entity does not apply fair value to the acquired assets, but retains the valuation used by the entity that previously held them. The method applied when accounting for an amalgamation is called the **pooling of interest method**.

The difference between the methods used for acquisitions and amalgamations are set out in the table below:

Accounting topic	Acquisition method	Modified pooling of interest method
Assets and liabilities	• All identifiable assets and liabilities are recognised at their acquisition date at fair value (some exceptions apply) • Classifications and designations can be updated based on terms and conditions existing at the date of the combination (exceptions apply)	• Assets and liabilities are recorded at their previous carrying values with no fair value adjustments • Classifications and designations previously applied by combining operations are retained but adjustments to achieve uniform accounting policies are permitted
Intangible assets and contingent liabilities	• Recognised if separable and/or arise from contractual or legal rights and the fair value is reliably measurable • Assets not recognised by the acquiree such as internally developed intangibles can be recognised by the acquirer if they meet the above criteria	• Recognise only to the extent that they were already recognised in the combining entities prior to the amalgamation

Accounting topic	Acquisition method	Modified pooling of interest method
Goodwill	• Goodwill is recorded if the amount paid for an entity exceeds the identifiable net assets (and value of non-controlling interests if applicable) • Subject to annual impairment testing	• No goodwill is recognised. Instead, the difference between the assets and liabilities recognised is presented in reserves. • Presentation in reserves either as a single opening balance or across multiple categories
Non-controlling interest	• Measured at their fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets	• Measured at their carrying amounts but adjusted for their proportionate share of adjustments made to harmonise accounting policies
Costs of the combination	• Acquisition-related costs such as advisory, legal, accounting, valuation etc are expensed in the period in which they are incurred	• Same treatment as for the acquisition model – costs are written off immediately in profit and loss
Profit or loss	• Includes results of the combining entities from the date of the business combination	• Statement of financial performance from amalgamation date to the reporting date
Comparatives	• No restatement	• Optional

Source: Grant Thornton ***https://www.grantthornton.global/globalassets/1.-member-firms/global/insights/article-pdfs/ifrs/ifrs-viewpoint-4---common-control-business-combinations.pdf***

Both the acquisition method and the pooling of interest method are designed to be applied in different scenarios, with the pooling of interest method best suited to machinery of government changes. Subsequent to the amalgamation, assets, liabilities and equity will be accounted for using the newly amalgamated entity's accounting policies.

E.5 Public sector combinations

5.1 Introduction

Financial reporting for group entities in the public sector involves the application of specialised accounting principles to ensure transparency, comparability, and accountability. Public sector combinations, such as mergers or acquisitions of government agencies or entities, present unique challenges for group accounting due to their non-commercial objectives and regulatory environments. This set of notes provides an

overview of public sector combinations, discusses the classification of such combinations, and explains the accounting treatments applied, with a particular focus on the modified pooling of interests method and subsequent accounting for amalgamations.

5.2 Public Sector Combinations

5.2.1 Definition and Types

A public sector combination refers to the bringing together of two or more public sector entities into a single reporting entity. These combinations can occur for a variety of reasons, including the pursuit of greater efficiency, policy alignment, or improved service delivery. The two primary types of public sector combinations are:

Amalgamation: The combination of two or more entities into a new entity, with neither party identified as the acquirer or acquiree. Control is shared or redefined, and the resulting entity is substantively different from the combining entities.

Acquisition: One entity obtains control over another entity or its operations. The acquiring entity is clearly identified, and the acquired entity may cease to exist as a separate legal entity.

5.3 Example

Consider the case where City Hospital and County Health Services, both public sector entities, are combined under a new regional health authority. Both entities cease to exist as separate legal entities, and a new entity is formed to assume their functions and assets. This scenario is classified as an amalgamation because it results in the creation of a new reporting entity, and neither pre-existing entity is considered the acquirer.

5.4 Group Accounting

5.4.1 Principles for Public Sector Combinations

Group accounting in the public sector aims to present the financial position and performance of the group as a single economic entity. Key principles include:

- Consolidation: Combining the financial statements of the controlling and controlled entities, eliminating intra-group transactions and balances.
- Uniform Accounting Policies: Ensuring consistent application of accounting policies across all group entities.
- Timely Reporting: Synchronising reporting periods for all entities within the group.

5.5 Consolidation Requirements

Consolidation is required when a public sector entity has control over one or more other entities. Control is typically evidenced by the power to govern financial and operating policies. For amalgamations, the new entity prepares consolidated financial statements that include the assets, liabilities, revenues, and expenses of the combining entities as if they had always operated as a single entity.

5.6 Modified Pooling of Interests Method

The modified pooling of interests method is an accounting approach used in

amalgamations where no acquirer is identified. Under this method, the assets and liabilities of the combining entities are brought together at their carrying amounts, rather than their fair values, and no goodwill or gain on combination is recognised.

5.6.1 Application Steps

- Identify all assets, liabilities, and reserves of the combining entities as of the amalgamation date.
- Aggregate the carrying amounts of these items, making necessary adjustments for uniform accounting policies.
- Recognise any difference between the aggregated net assets and the face value of equity instruments issued as an adjustment to a separate reserve (e.g., amalgamation reserve).
- Eliminate intra-group balances and transactions in the consolidated financial statements.

5.6.2 Measurement Period

The measurement period is the timeframe within which the combining entities finalise the identification and measurement of assets and liabilities. Adjustments to provisional amounts are permitted during this period, which typically does not exceed one year from the amalgamation date. After the measurement period, no further adjustments are made to reflect new information regarding conditions that existed at the amalgamation date.

5.7 Subsequent Accounting for Amalgamations

5.7.1 Treatment of Assets, Liabilities, and Equity

Following an amalgamation, the new reporting entity accounts for the assets and liabilities received at their carrying amounts as recognised by the combining entities immediately prior to the amalgamation. Depreciation and amortisation policies continue based on these carrying amounts, adjusted for any changes in accounting policies required for consistency.

Equity issued in the amalgamation (such as shares or other ownership interests) is recognised at nominal or face value. Any surplus or deficit arising from the aggregation of net assets and the face value of equity issued is recorded in a separate reserve, often termed the amalgamation reserve. This reserve is presented within equity and is not recycled through profit or loss.

Example

Using our earlier Example, the new regional health authority recognises the land, buildings, equipment, and liabilities of City Hospital and County Health Services at their existing carrying amounts. Any difference between the total net assets received and the nominal value of shares issued to previous stakeholders is credited to the amalgamation reserve. Depreciation continues on the assets based on their pre-amalgamation carrying amounts.

5.8 Conclusion

Public sector combinations require careful consideration of the nature of the combination—amalgamation or acquisition—to determine the appropriate accounting method. The modified pooling of interests method is applied in amalgamations, ensuring assets and liabilities are carried forward at their existing values and equity issued is accounted for at face value. Understanding these principles is essential for transparent and consistent financial reporting in the public sector, supporting accountability to stakeholders and the public.

Summary of Unit E and key learning outcomes

Unit D deals with the key competency 'Preparation of the financial statements of group entities. In this unit, we looked at the following learning outcome:

Learning outcome	
Preparation of consolidated financial statements	You should now be able to prepare the consolidated statement of financial position and the consolidated statement of profit or loss for a parent and subsidiary, as well as an associate and joint venture using equity accounting. You should also be able to prepare a simple consolidated Statement of Cash Flows.

Quiz questions

1	E.1
Company A is the parent of four companies. Under which one of the following circumstances would it not be required to apply IFRS 10 in preparing consolidated financial statements:	
A	Company A is publicly listed
B	Company A issues bonds on the London Stock Exchange
C	Company A is a subsidiary of Company Z, which is listed on the New York Stock exchange and applies US GAAP
D	Company A is an investment company

2	E.1
Company L has acquired asset P in a transaction. Which one of the following indicates that that P represent a business:	
A	P's outputs are not sold on the open market
B	P provided investment services within its previous group
C	L paid 30% of its retained earnings to purchase P
D	L has acquired 60% ownership over P

3	E.1
Company D acquires 75% of the shares of Company S on 31 December 20X5, for 100. The net assets of S recognised at the reporting date were valued at 120. The NCIs are measured proportionately to the fair value of the net assets. What is the value of goodwill reported in D's Statement of Financial Position	
A	10
B	190
C	50
D	5

4	E.1

Parent Company Y's statement of financial position includes a loan principal receivable from subsidiary Company K of 150 balance at the year-end, which it repays at 30 per year. Which of the following represents the correct accounting entry to adjust for this loan on consolidation:	
A	Dr: Company K's current liabilities 150, Cr: Company Y's current assets 150
B	Dr: Company K's non-current liabilities 150, Cr: Company Y's non-current assets 150
C	Dr: Company K's retained earnings 150, Cr: Company Y's equity 150
D	Dr: Company Y's retained earnings, Cr: Company K's equity

5	**E.1**
Parent Company V holds 65% of the shares of subsidiary Company B. At year end, operating profit of Company B is 300, including revenue of 60 generated from sales to V, on which a profit of 20 was made and remained unrealised at the year-end. What is the value of the profit attributable to the NCI:	
A	135
B	99
C	108
D	126

6	**E.1**
Company Q's profit and loss show taxes paid at 31 March 20X5 of 70. The tax payable balance at 31 March 20X4 was 60 and the amount shown in payables at 31 March 20X5 is 45. What is the correct tax paid figure to use on the Statement of Cash Flows:	
A	85
B	35
C	55
D	115

7	E.2
Which one of the following correctly describes the difference between an associate and a joint arrangement	
A	Joint venturers do not have significant control
B	Associates make decisions on a majority vote basis
C	Associates require a separate vehicle, whereas joint ventures do not
D	Joint ventures are defined by unanimous control, whereas associates are not

8	E.2
Parent G acquires fixed assets from Associate X, in which it holds a 25% shareholding. The fixed assets are carried in X's books at 420, and G pays 380 consideration to acquire them, thereby indicating a reduction in the net realisable value of the assets. Which one of the following shows the correct accounting entry to adjust for the impairment identified in G's financial statements:	
A	Dr: Impairment 10, Cr: Investment in associate 10
B	Dr: Impairment 40, Cr: Investment in associate 40
C	Dr: Impairment 10, Cr: Fixed assets 10
D	Dr: Impairment 40, Cr: Fixed assets 40

9	E.4
Which one of the following correctly describes the recognition and presentation criteria applied under the modified pooling of interest method:	
A	Comparative figures are required for all financial statements
B	Acquisition costs are expensed on recognition
C	NCI is measured at their share of the fair value of the investee's net assets
D	Intangible assets are recognised if they meet the requirements of IAS 38

Unit F: Analysis and Interpretation

Learning outcomes

F.1	Analysis and interpretation of financial and non-financial information
F.2	Analysis and interpretation of financial statements of public-sector organisations

Introduction to Unit F

This Unit applies the information you learned in Unit E of Financial Reporting, where you were introduced to the calculation of basic ratios.

Due to the relatively low weighting of this Unit in the overall syllabus, it attracts a maximum of 8 marks in the exam, and will thus be examined by asking you to apply ratios to financial statements information that you have prepared yourself in other questions from Units D and E.

F.1 Analysis and interpretation of financial and non-financial information

1.1 Introduction

In this part of the Unit we will look at a case study based on a significant business operating in Rwanda, allowing us to apply the ratios you learned in Financial Reporting directly to real world financial results, and then interpret those results within a specific context. The Example has been simplified considerably, but the purpose is not to perform an accurate assessment of a specific company, but to apply the principles of financial interpretation that have comprised a significant part of this whole syllabus. Effective interpretation requires an advanced degree of accounting knowledge, since this is the only way that the interconnections between elements of the financial statements, such as the relationship between revenue and receivables, can be properly interrogated. Understanding how the appropriate accounting policies have been applied is another demanding application of accounting knowledge. While we have standardised ratios to apply in order to assess liquidity, or profitability, for Example, we often have to make adjustments for things like cash taxes paid, that require us to know where to find the correct figure. As we will see in the case study, ratio results without context are not very informative, and one aspect of interpretation that should be clear by the end of this Unit is that some degree of industry specific knowledge is invaluable in interpreting ratios. Before we commence the case study, we will briefly review the main financial ratios from Financial Reporting. Ratios are very widely used and there are many useful websites which explain the logic of the ratios, provide Examples of their application, and explain specific risks and limitations that they may present. You should therefore supplement the Financial Reporting textbook with wider research to assist you in understanding and applying ratios.

1.2 Financial Ratios

1.2.1 Profitability ratios

The usefulness of the figures shown in the statement of profit or loss will be greatly enhanced by expressing profit as a percentage of revenue or capital employed, thereby allowing comparison with previous years and other organisations. In addition, these ratios will provide an indication of how well an organisation controls its costs. The most commonly used profitability ratios are:

Ratio	Formula
Return on capital employed (%) (ROCE)	(Profit from operating activities / capital employed) x 100
Return on equity (ROE) (%)	(Profit from operating activities / shareholders' funds) x 100
Net profit margin (%)	(Profit from operating activities / revenue) x 100
Gross profit margin (%)	(Gross profit / revenue) x 100

1.2.2 Efficiency (or working capital) ratios

To be successful it is essential that a business makes good use of its assets. We can get an indication of this through calculating the following ratios:

Ratio	Formula
Turnover of capital employed or Asset turnover (times)	Revenue / capital employed
Non-current asset turnover (times)	Revenue / non-current assets
Current asset turnover (times)	Revenue / current assets
Average inventory days	(Average inventory / cost of sales) x 365
Average trade payables days	(Average trade payables / credit purchases) x 365

1.2.3 Liquidity ratios

Of crucial importance to any organisation is its ability to generate cash and be able to meet day-to-day debts as they fall due. To help assess an organisation's liquidity we use the following ratios:

Ratio	Formula
Current ratio	Current assets / current liabilities

Ratio	Formula
Quick ratio (or acid test)	(Current assets - inventory) / current liabilities
Both these ratios are expressed as X:Y, (e.g. 2:1, 1.5:1)	

Care must be taken when interpreting the current ratio and in particular it is important to consider the makeup of current assets. If current assets predominately comprise inventory and receivables, then a business with a healthy current ratio might still experience liquidity problems since it is not always easy to turn these assets into cash at short notice. For this reason, the acid test ratio should be used in conjunction with the current ratio. 1.2.4 Long term solvency and debt ratios

Investors and lenders will be interested in an organisation's long-term funding arrangements and in particular its dependence on borrowed funds. The greater an organisation's dependence on borrowed funds, the higher the risk that it will be unable to meet interest and capital repayments when they become due. The following ratios assist our understanding of this area.

Ratio	Formula
Gearing (%)	(Non-equity finance / capital employed) x 100
Interest cover (times)	Profit from operating activities / finance costs

1.2.5 Shareholder investment ratios

Of prime concern to investors are the likely return from and the level of risk attached to an investment. We will consider the following ratios to assess the return to investors:

Ratio	Formula
Ordinary dividend cover (times)	Profit attributable to ordinary shareholders / ordinary dividends
Earnings per share (Basic) (EPS)	Profit attributable to ordinary shareholders / number of ordinary shares

F.2 Analysis and interpretation of financial statements of public-sector organisations

2.1 Introduction

Most of the main issues relating to the interpretation of public sector financial statements were covered in Financial Reporting, where the following key items were noted:

- Some definitions may need to be modified to reflect the terminology and structure of IPSAS statement: e.g. use of 'operating surplus' rather than 'profit before interest and tax'.

- Some public sector organisations have limited control over some aspects of their finances; organisations may be largely funded by a grant from an external body, rather than being able to generate their own income from sales.
- Public sector organisations may have different objectives, with little or no emphasis on profit as an objective.
- Public sector organisations tend to have a wide range of stakeholders, so it is not always straightforward to identify ratios or other performance measures that are relevant to all potential stakeholders.
- Some organisations are given targets to achieve in the year, and performance should be assessed against these targets rather than against past performance or the performance of other organisations.
- Organisations may have to operate in the context of statutory targets; e.g. an education authority may not be legally permitted to have classes above a certain number of students.
- Competition is less of an issue in the public sector, so comparisons with other organisations may be carried out for different reasons, eg benchmarking, continuous improvement, rather than to become more competitive.

The main point to understand is that the issues which many ratios address are often not very relevant to the public sector, with the exception of the liquidity and efficiency ratios, which are always relevant because public sector entities need to manage their working capital in the same way that every business does. One factor which was not emphasised in Financial Reporting but may be very important depending on the context, is the potential use of non-standard financial statements which are designed in accordance with a mandatory reporting framework, such as the UK's Financial Reporting Manual, which is applied by Central Government (but not local authorities). These alternative formats usually follow standard accounting practice (IFRS in the UK) but the layout of the alternative statements are quite different.

While liquidity is always relevant to suppliers and other creditors, and users will often be interested in how quickly a public sector body pays its bills, long term solvency is not usually relevant. This is because most public sector bodies are established for the purpose of implementing certain policies or administering certain processes, and hence act as an extension of central government. As a result, they will carry a more or less explicit guarantee from central government as to their long-term solvency, and are typically as exposed to default as the national government, or state, is. This is also why going concern as an accounting concept is nowhere near as important for specific public sector entities as it is for private sector ones.

It should be noted that in many jurisdictions, any guarantees from central government are accompanied by strict rules about what types of financial risk the entity is allowed to expose itself to. There are likely to be restrictions on where they can invest, and what types of financial instruments they can utilise. That said, in the SOE sector many entities need to utilise more complex instruments such as hedges, and where they generate revenue and come closest to private sector companies, they are more exposed to solvency risks. Indeed, according to the Rwanda Office of the Auditor General of State Finances 2022 report, a number of Rwandan Government SOEs reported low solvency ratios at year end.

Summary of Unit F and key learning outcomes

In this unit, we looked at the following learning outcome:

Learning outcome	
Analysis and interpretation of financial and non-financial information	You should now be able to analyse and interpret financial information by comparing different sources of information, applying professional scepticism and communicate the implications of your analysis depending on the context.
Analysis and interpretation of financial statements of public-sector organisations	You should now be able to understand some of the key issues in analysing and interpreting public sector financial information.

Quiz questions

Case Study 1

Overview of CIMERWA

CIMERWA is a formerly state-owned cement company established to provide for the needs of Rwanda, with a theoretical maximum annual production capacity of 600,000 tonnes that matches Rwanda's annual requirement.

It was acquired in January 2024, when its shareholders at that time including PPC International Holdings (South Africa), the Rwanda Social Security Board, Rwanda Investment Group, SONARWA General Insurance Company Holdings, and Agaciro Development Fund, all of which are Rwandan companies, sold CIMERWA to a Kenyan Cement company. The 2023 financial statements assert that the Rwandan shareholders held around 37% of the shares between them, and that CIMERWA is controlled by PPC International Holdings (South Africa).

As a result of this transaction, CIMERWA is no longer listed on the Rwandan Stock Exchange. However, it continues to operate in Rwanda under its Kenyan parent and will continue to issue financial statements. The users of its financial statements will thus most likely comprise regulators, lenders and other suppliers of credit.

Scenario

This scenario takes place before the sale of CIMERWA to a Kenya's Cement company

You are a newly appointed credit controller at a multinational company that sells packing supplies to manufacturing companies, including bags for cement. Your employer has recently opened an office in Kigali and is interested in selling to CIMERWA, as well as other national manufacturers, on credit. You have therefore decided to review CIMERWA's financial statements for the last two years to assess the different dimensions of its financial performance, in order to determine what level of credit the company might extend.

Because you are new to the cement industry, the credit clerk shared with you an article from the industry press providing average ratios for cement businesses internationally. Only the current and fixed asset turnover ratios were directly relevant to your review, so you have extracted them for comparison.

You will prepare some of the simpler credit assessment ratios and write an analysis of your interpretation of them using the available information, including management commentary and other sources.

You will calculate the following ratios using extracted information from the CIMERWA 2022 financial statements:

Profitability:	Net profit margin
	Return on assets
Leverage:	Debt to assets ratio
Coverage:	Interest cover ratio
	Debt service coverage ratio

Additional Information Available

CIMERWA MISSION AND VISION

Our Mission – At its core, CIMERWA is fully focused on the journey of Strengthening Rwanda in a pursuit to lay strong foundations for future generations.

Our Vision – To be the leading producer and supplier of quality cement and related products as well as solutions in the GREAT LAKES REGION while maximizing stakeholder value.

NEWS

https://www.globalcement.com/news/item/16696-cimerwa-raises-sales-in-2023-financial-year

https://www.businessdailyafrica.com/bd/markets/market-news/devki-s-national-cement-completes-buyout-of-cimerwa--4507530

https://www.constructionkenya.com/5331/rwanda-cement-market/

NEWS REPORT

For more than 30 years, CIMERWA, which has enjoyed a dominant position in the market, has struggled to meet demand, forcing the country to import additional cement for its growing construction needs.

Despite having an annual installed capacity of 600,000 tonnes, CIMERWA's production oscillates between 35% and 50%, hence its inability to meet the country's demand.

https://www.constructionkenya.com/5331/rwanda-cement-market/

The EastAfrican HOME NEWS BUSINESS & TECH OPINION SUSTAINABILITY MAGAZINE

in the East African region and strong growth ambitions in tune with the region's infrastructure development imperative.

CIMERWA, is majority-owned by PPCIH, with a 51 percent stake, while the remaining 49percent is distributed among minority shareholders, including Rwanda Social Security Board (RSSB), Agaciro Development Fund, Rwanda Investment Group and SONARWA General Insurance Company Holdings Ltd.

With strong support from its leadership team and shareholders, the company has achieved remarkable improvements in both operational efficiency and financial performance in past years.

https://www.theeastafrican.co.ke/tea/partner-content/national-cement-holdings-ltd-acquires-99-9pc-stake-in-cimerwa-rwanda-s-top-cement-producer-4439792

NOTE URL "partner content" = likely written by CIMERWA

Management Commentary from the 2022 Annual Report (CEO's report – extract)

Financial Performance

Profit Before Tax (PBT) stood at Frw 16.9 bn, an impressive improvement of 212% versus prior year. This was on account of the operating profit improvement driven by sales volumes being 27% higher than prior year supported by price optimization, cost management initiatives resulting in improved margins. Our finance costs also declined in line with the reduced debt facility following voluntary early loan repayment during the year in line with the facility agreement.

The above profitability performance drove our Earnings Per Share (EPS) up to Frw 18.74, an excellent improvement of 220% compared to the prior year EPS of Frw 5.86. Following this strong performance, the Board of Directors recommends a dividend payout of Frw 10.5 bn, representing 80% of Profit After Tax, subject to shareholder approval at the Annual General Meeting.

We closed the year with a healthy cash position of Frw 20 billion, a 40% increase versus last year. Our net debt reduced from Frw 21bn last year to Frw 1bn as at 30th September 2022 hence leaving the Company with a healthy balance sheet.

Comparative Ratio Analysis

The industry article cites the following averages for the Current and Fixed Asset Turnover ratios. These have been compared to CIMERWA's results for the same periods, as follows:

CIMERWA	AVERAGE	CIMERWA/ AVERAGE
		CIMERWA results divided by average
		Positive numbers indicate a higher relative performance

Current Ratio

Financial Year	Ratio
2022	1.73
2021	1.52
2020	1.61

Current Ratio

Financial Year	Ratio
2022	1.49
2021	1.25
2020	1.50

Financial Year	Ratio
2022	1.16
2021	1.22
2020	1.07

Fixed Asset Turnover

Financial Year	Ratio
2022	1.21
2021	0.82
2020	0.75

Fixed Asset Turnover

Financial Year	Ratio
2022	1.02
2021	0.84
2020	0.82

Financial Year	Ratio
2022	1.19
2021	0.98
2020	0.91

Financial Statement Extracts

The information shown below has been extracted from the CIMERWA financial statements and set out in accordance with the relevant ratios.

Interest Cover	**2022**	**2021**
Net profit	16,860	5,401
Interest expense	3,686	1,281
Debt service coverage ratio		
Net profit	16,860	5,401
Cash taxes paid	11,198	13,108
Interest paid	4,106	5,552
Debt to assets ratio		
Total funded debt	21,180	35,251

Total assets	115,627	109,570
Return on assets ratio		
Net profit	16,860	5,401
Opening assets	109,569	112,252
Closing assets	115,627	109,569
Net assets	112,598	110,911
Net profit margin		
Revenue	92,087	67,374
Net profit	13,175	4,120

The financial ratios are calculated using the formulae you learned in Financial Reporting.

The results of the analysis are shown below:

Interest Cover		**2022**	**2021**	
		4.57	4.22	**Note:** *In 2022, CIMERWA's earnings were able to cover its interest expense obligations at a ratio of 4.57*
		0.14	0.06	**Note:** *For every 1 FRW of revenue generated, 14 centimes is available in 2022 to distribute to shareholders or fund activity.*

Interpretation and Commentary

Generally speaking, the 2022 ratios are quite positive. CIMERWA has a reasonably low debt load, as indicated by the debt to assets ratio, and is able to service its financial obligations, including taxes.

ROA

A 15% return on assets appears reasonable, particularly given that CIMERWA is a capital-intensive business, and the assets of this type of company typically generate a lower return.

DSCR

The ratio of 1.38 is important, as many medium size companies will only extend credit if this ratio is at a minimum of 1.25. However, the very weak ratio in 2021 would suggest that a longer-term analysis should be undertaken, to determine what the real historic pattern is.

Management Commentary

Given the 2021 results, the CEO is probably entitled to celebrate the improved performance of the company. An 80% profit distribution is excellent news for shareholders, specifically given that the company has settled debt obligations early. However, it also suggests that

the company is establishing the conditions to enable a sale, (as we will see in 2023) because the money could be usefully applied to expanding the business. Indeed, we learned from the constructionkenya.com article, the company has a history of not operating at full capacity, which means that it probably needs to spend money to expand output.

Comparative Ratios

The comparative performance of CIMERWA in terms of its fixed asset turnover and current ratios seems to be in line with, or slightly better than its peers. CIMERWA appears to manage its working capital effectively, and its fixed assets generate sales in line with the industry. This is important for a supplier intending to extend credit to CIMERWA, as it suggests that they keep cash on hand to pay suppliers.

Conclusion

CIMERWA represents a reasonably safe risk in terms of extending credit for relatively low value products like cement bags. Its historic performance should be investigated further to determine whether it is on a path of sustainable growth, or if its 2022 results are not to be repeated. In the light of the large dividend payout and early settlement of debt mentioned in the CEO's report, it is likely that the business is consolidating, rather than expanding. So they may not represent a growth customer for the company but they have cash on hand and low debt and represent a low risk of defaulting.

Quiz 1

Consider the different sources of information made available in the case study: how do you assess their usefulness, in terms of reliability and relevance? In order to effectively engage with the different sources, what essential principal should be applied?

Case study 2

Below you will see the UK Department of Education income and expenditure statement:

Consolidated Statement of Comprehensive Net Expenditure

For the year ended 31 March 2024

		2023-24		2022-23	
		Department & Agecies	Group	Department & Agecies	Group
	Note	£ m	£ m	£ m	£ m
Income	3	(310)	(634)	(383)	(665)
Total income		**(310)**	**(634)**	**(383)**	**(665)**
Staff costs	4	517	793	524	762
Policy funding:	5				
resource		81,059	80,673	75,926	75,613

Consolidated Statement of Comprehensive Net Expenditure

For the year ended 31 March 2024

		2023-24		2022-23	
		Department & Agecies	Group	Department & Agecies	Group
	Note	£ m	£ m	£ m	£ m
capital		5,970	6,152	5,708	5,804
Purchase of goods and services	6.1	275	466	235	426
Depreciation, amortisation and other non-cash charges	6.2	231	296	309	374
Total operating expenditure		**88,052**	**88,380**	**82,702**	**82,979**
Net operating expenditure		**87,742**	**87,746**	**82,319**	**82,314**
Finance income		(3)	(22)	(4)	(23)
Finance expense		50	72	49	67
Other losses/(gains)	7	2,582	2,582	(23,778)	(23,778)
Net expenditure for the year		90,371	90,378	58,586	58,58
Other comprehensive expenditure					
Items that will not be reclassified to net operating costs:					
net gain on revaluation of property plant and equipment, right-of-use assets and intangible assets		_	(2)	_	_
actuarial (gain)/loss on defined benefit pension scheme		_	1	_	19
Total other comprehensive expenditure		**_**	**(1)**	**_**	**19**
Comprehensive net expenditure for the year		**90,371**	**90,377**	**58,586**	**59,599**

Note that for the UK, income is more or less insignificant to the purpose of this report, it is not even referred to in the name. This is typical of entities within the General Government Sector internationally, as revenue generation is by definition not important to their operations. Thus, there are no divisions between gross, operating and net profit, although the statement follows IFRS 18 by including finance income separate to its main source of income. Expenditure is also analysed differently to most private sector companies, comprising staff costs, policy related expenditure (operations), purchases and non- cash items. These disclosures are intended to meet quite different user needs than those assumed to be relevant under IFRS 18.

The financial statements produced by the Government of Rwanda in 2022 were in partial compliance with IPSAS in accordance with the government's plan to implement accrual IPSAS over a six-year period. The layout of the financial statements is however in accordance with IPSAS 1, and the Rwandan equivalent of the UK statement is shown below for comparison:

4. STATE CONSOLIDATED FINANCIAL STATEMENTS

4.1. Government of Rwanda Consolidated Statement of Revenues and Expenditure for the Year Ended 30 June 2022

Description	Notes	12 months to 30 June 2022 Frw	12 months to 30 June 2021 Frw
Revenues			
Tax Revenues	4.7.14	1,889,507,283,827	1,640,627,532,030
Fines penalties and forfeits	4.7.15	34,029,957,853	28,615,816,661
Grants received	4.7.16	678,876,512,111	527,874,263,907
Transfers other than grants	4.7.17	74,276,493,416	19,590,773,488
Sales of goods and Services	4.7.18	437,968,051,168	450,577,859,411
Other revenue	4.7.19	73,896,986,405	35,531,866,902
Domestic borrowings	4.7.20	279,850,064,803	304,207,199,626
External borrowings	4.7.21	1,303,985,229,255	690,509,457,378
Total Revenue		**4,772,390,578,838**	**3,697,534,769,403**
Expenditure			
Wages, Salaries and Employee Benefits		650,783,945,278	580,131,003,931
Use of Goods and Services		1,574,133,002,219	1,280,629,366,697
Capital Expenditure		651,150,021,677	1,305,400,286,196
Finance cost		260,611,893,607	186,544,427,030
Subsidies		377,574,046,053	25,312,436,444
Grants awarded		139,346,791,538	103,034,536,948
Social Assistance		180,213,407,215	162,784,759,454
Other Expenses		253,112,061,520	188,252,366,468
Repayment of borrowings		497,499,850,701	114,342,591,824
Total Expenses		**4,584,425,019,808**	**3,946,431,774,992**
Other gains and losses			
Foreign exchange gain	4.7.31	28,231,738,285	31,675,337,952
Foreign exchange loss	4.7.32	(19,607,940,473)	(13,187,790,002)

4. STATE CONSOLIDATED FINANCIAL STATEMENTS

4.1. Government of Rwanda Consolidated Statement of Revenues and Expenditure for the Year Ended 30 June 2022

Description	Notes	12 months to 30 June 2022 Frw	12 months to 30 June 2021 Frw
Total other gains and losses (C)		**8,623,797,812**	**18,487,547,950**
Net surplus / (deficit)		**196,589,356,842**	**(230,409,457,639)**

As you can see this approach is closer to IFRS 18in keeping revenue at the top of the statement, but it does not include anything resembling cost of sales, or profit analyses. Unlike the UK statement it does not analyse expenditure by the type of activity undertaken (except for social assistance), but by nature.

Quiz 2

Whereas the UK statement rounds to the nearest Million Pounds, the Rwandan statement uses no rounding at all, despite the fact that revenues and expenses each exceed 4 trillion Rwandan Francs. Do you think it is more important for users to understand the exact amount reported, or should the numbers be rounded off so that they can be more easily understood?

Unit G: Current Developments

Learning outcomes

G.1 Discussion of solutions to current issues in financial reporting.

Introduction to Unit G

In Financial Reporting, Unit F, you were introduced to the types of projects carried out by the IASB and IPSASB to maintain and develop standards for both the private and public sectors. This included Examples of key projects that are underway in 2024, and the IFRS or IPSAS standards that are affected by these projects. This Unit aims to expand your understanding of the standards and regulations that affect us as professional accountants by explaining the rules which aim to address money laundering, and looking in more detail at the sustainability standards that were introduced in Unit B of this workbook. The discussion includes consideration of the implications of these rules and standards for professional accountants.

G.1 Discussion of Solutions to Current Issues in Financial Reporting

1.1 Sustainability Reporting

1.1.1 Introduction

As was noted in Unit B, one of the main recent developments under IFRS is the emphasis on the importance of supporting financial reporting with other relevant contextual information. The key risks currently perceived by standard setters as needing additional disclosure can be broadly defined as relating to sustainability – an attempt to focus disclosures more on the long-term risks facing businesses, specifically with regard to climate change. This new emphasis has been formalised by establishment of The International Sustainability Standards Board (ISSB), and the launching of inaugural IFRS Sustainability Disclosure Standards, which were introduced in Unit B but will be explored in more detail here. 1.1.2 Developments

The ISSB's IFRS Sustainability Disclosure Standards currently consist of:

- IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and
- IFRS S2 *Climate-related Disclosures*

According to the ISSB, the standards aim to provide "a global baseline of sustainability-related disclosures aimed at the capital markets". In other words, the focus is on improving the information available to investors in publicly listed companies. However, as was noted

in Unit B, the IPSASB follows the lead of the IFRS and can be expected to adapt the ISSB standards to the public sector.

IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*

IFRS S1 is effective for annual reporting periods beginning on or after 1 January 2024 with earlier application permitted as long as IFRS S2 Climate-related Disclosures is also applied.

The objective of IFRS S1 is to require an entity to disclose information about its sustainability-related risks and opportunities that is useful to users of general-purpose financial reports in making decisions relating to providing resources to the entity.

IFRS S1 requires an entity to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term (collectively referred to as 'sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects').

IFRS S1 prescribes how an entity prepares and reports its sustainability-related financial disclosures. It sets out general requirements for the content and presentation of those disclosures so that the information disclosed is useful to users in making decisions relating to providing resources to the entity.

IFRS S1 sets out the requirements for disclosing information about an entity's sustainability-related risks and opportunities. In particular, an entity is required to provide disclosures about:

- The governance processes, controls and procedures the entity uses to monitor, manage and oversee sustainability-related risks and opportunities;
- The entity's strategy for managing sustainability-related risks and opportunities;
- The processes the entity uses to identify, assess, prioritise and monitor sustainability-related risks and opportunities; and
- The entity's performance in relation to sustainability-related risks and opportunities, including progress towards any targets the entity has set or is required to meet by law or regulation.

IFRS S2 Climate-related Disclosures

IFRS S2 is effective for annual reporting periods beginning on or after 1 January 2024 with earlier application permitted as long as IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information is also applied.

The objective of IFRS S2 is to require an entity to disclose information about its climate-related risks and opportunities that is useful to users of general-purpose financial reports in making decisions relating to providing resources to the entity.

IFRS S2 requires an entity to disclose information about climate-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term (collectively referred to as 'climate-related risks and opportunities that could reasonably be expected to affect the entity's prospects').

IFRS S2 applies to climate-related risks to which the entity is exposed, which are:

- Climate-related physical risks; and
- Climate-related transition risks; and
- Climate-related opportunities available to the entity.

Physical risks here relate to the impact of environmental change, for Example increased risk of flood or storm, on the company's physical assets; transition risks relate to company plans to reduce the extent to which it depends upon and or emits greenhouse gases; and opportunities may lie in gaining competitive advantage by way of responding to climate risk, or of accessing government funds to support transition.

IFRS S2 sets out the requirements for disclosing information about an entity's climate-related risks and opportunities. In particular, IFRS S2 requires an entity to disclose information that enables users of general-purpose financial reports to understand:

- The governance processes, controls and procedures the entity uses to monitor, manage and oversee climate-related risks and opportunities;
- The entity's strategy for managing climate-related risks and opportunities;
- The processes the entity uses to identify, assess, prioritise and monitor climate-related risks and opportunities, including whether and how those processes are integrated into and inform the entity's overall risk management process; and
- The entity's performance in relation to its climate-related risks and opportunities, including progress towards any climate-related targets it has set, and any targets it is required to meet by law or regulation.

1.1.3 Implications

Companies that apply the ISSB standards will need to develop a suite of governance and performance management arrangements supported by appropriate business processes to enable production of the risk management information which the standards mandate. Both standards specify that the information should cover cash flows, access to finance and cost of capital. So, companies must assess whether their sustainability risks could impact on operations, like the sudden closure of a factory which has failed an environmental inspection; as well as its ability to raise funds, perhaps because its reputation has been tarnished by negative press about one of its suppliers dumping toxic waste.

Governance processes will involve establishing a sub-committee or equivalent of the company board with specific roles reporting to that body on sustainability related matters. The method by which these risks will be managed and reported will be set forth in a strategy which aligns the company's long-term plans to its need to manage sustainability and climate change. The strategy will in turn be realised by the development of new processes to obtain information across the business about sustainability related risks. For Example, a multinational retail company will have to establish mechanisms to assess the risks that it is exposed to through its suppliers: is the palm oil the company uses sustainable? Are the offshore clothing factories it uses following local rules around pollution? The information gathered from these processes will need to be auditable, which will mean undertaking inspections of suppliers and ensuring that they are committed to complying, and documenting their compliance, with the standard's requirements.

Many companies do already monitor this type of risk and reports surface periodically in the press about one major multinational or another being caught for using unsustainable resources or polluting the local environment. However, the ISSB standards formalise the disclosure requirements and make it harder for companies to selectively choose what they want to report.

The first and most obvious implication of introducing these standards is that the new monitoring and reporting processes will be expensive, particularly for multinational companies. Lots of consultants will be paid to develop strategies and processes, and new experts and auditors will need to be employed to manage those strategies and processes. The new standards will also need to be explained to investors so that they are able to make useful decisions based on the information the standards provide. Hence the focus on listed companies, which are more capable of absorbing the additional expense involved, and are assumed to have more sophisticated investors.

While the implications of implementing both standards are very similar, the standards themselves deal with separate issues: sustainability mainly applies to sourcing of resources, operational efficiencies and disposal of waste; climate change risks on the other hand are perhaps more difficult to quantify because of the complexity of accurately predicting changes in the global environment. An oil company with numerous off-shore platforms, for Example, will need to assess the risk to each one that a certain change in sea level over a certain number of years will result in adaptation costs as platforms need to be raised or moved. More specifically, IFRS S2 requires companies to report on how they plan to reduce greenhouse gas emissions going forward.

IFRS S2 mandates that companies conduct climate-related scenario analysis to evaluate their climate resilience. This analysis should use a suitable method, appropriate for their circumstances considering their exposure to climate-related risks and opportunities, as well as the skills, capabilities and resources that are available at the time of reporting. Companies will have to determine their approach to climate-related scenario analysis based on all reasonable and supportable information, and takes into account both the choice of inputs and the analytical decisions made when conducting the analysis.

One of the most significant tests for the new standards will be in the quality and reliability of the information they provide, given that this information will be underpinned by complex forecasting and thus potentially prone to both error and bias.

In terms of the specific implications of these standards for the financial reporting function, accountants will need to engage with experts in a wide range of fields and consider how the risks identified should be quantified and incorporated into the financial statements. In addition, audit firms will need to consider the extent to which their procedures are able to provide assurance over the analysis reported and the assumptions applied.

1.2 Anti Money Laundering

1.2.1 Introduction

Regulations governing financial reporting are often country specific but there are certain regulatory frameworks that are used internationally and adapted into country's legal codes. One important Example which directly impacts professional accountants is Anti Money Laundering (AML) rules, and we will introduce the key requirements in the following section.

Money laundering is the concealment of the origins of money gained from crimes, including tax evasion, human trafficking, drug trafficking, and public corruption. It also includes money being illegally routed to terrorist organisations.

Money laundering can be divided into three steps:

- Depositing illicit funds into a financial system
- "Layering," or making a series of transactions, usually repetitive and voluminous, to obfuscate the illicit origin of the funds
- "Cleaning" and "washing" the funds by using them to buy real estate, shares, investments, and other legitimate assets

Anti-money laundering refers to a set of laws, regulations, and procedures designed to prevent criminals from disguising the proceeds of illegal activity as legitimate funds. AML regulations aim to prevent money laundering by ensuring that financial institutions, including accounting firms, have robust policies and procedures in place to detect, prevent, and report suspicious activity.

In Rwanda the AML rules were published in 2022 as Regulations relating to Anti-Money Laundering, Combating the Financing of Terrorism, and Financing of Proliferation of Weapons of Mass Destruction. The effectiveness of these regulations was assessed by The Financial Action Task Force (an international body which promotes AML) in 2024 and Rwanda was found to be making positive strides in modernising its mechanisms to monitor AML. 1.2.2 Implications

Accountants play a critical role in preventing money laundering. They are often the first line of defence against money laundering, as they are responsible for handling financial transactions on behalf of their clients. As such, accountants must be aware of their AML responsibilities and the key AML requirements that they must follow.

To comply with regulations, accounting firms must establish and maintain an AML compliance program. An AML compliance program should include policies and procedures that are designed to identify and assess the risk of money laundering and terrorist financing associated with the firm's clients and services. The program should also include procedures for verifying the identity of clients, monitoring transactions, and reporting suspicious activity. The AML rules apply to all accounting practices, including sole traders, so even if you are working in a very small firm, you must ensure that AML procedures are in place.

The first step that accountants must follow is to confirm their customer's identity, through procedures commonly referred to as Know Your Customer (KYC). For accountants in public practice, this involves establishing the beneficial ownership of a company the accountant is proposing to work for, including obtaining copies of personal identification documents. The purpose of KYC is to stop money laundering at the first step noted above, before the funds are deposited into the financial system.

Thereafter the accountant should establish customer due diligence procedures to monitor transactions to detect if the customer subsequently attempts to launder money. For Example, AML procedures tend to consider materiality, and a process may raise flags automatically on transactions over a certain value. However, a customer may subvert this procedure by dividing up an illicit transaction into smaller tranches that won't automatically be flagged. Due diligence thus tends to include verifying the identity of

clients, understanding the nature and purpose of their business relationships, and monitoring transactions to identify suspicious activity.

Suspicious activity can include transactions that are inconsistent with a client's known business or personal activities, transactions that involve large amounts of cash, or transactions that are designed to evade reporting requirements. They may also involve transfers to or from countries, or companies or individuals which are subject to international sanctions. Suspicious activity is normally reported to a dedicated government agency using a standard template provided in the relevant regulations. In Rwanda the agency responsible for monitoring AML compliance is the Financial Intelligence Centre.

It should be noted that the accountant's obligation to report suspicious activity under AML rules specifically overrides the duty of confidentiality that normally applies to all customer activity, as discussed in Unit A.

Accountants must keep records of their clients' transactions and the due diligence they conduct on their clients. These records should usually be kept for a minimum of five years, but this may vary by jurisdiction.

Summary of Unit G and key learning outcomes

In this unit, we looked at the following learning outcome:

Learning outcome	
Critically discuss developments in financial reporting standards, regulations and business practices, assessing implications for the financial reporting function and business processes.	You should now be able to critically discuss the main features of the new IFRS Sustainability Standards and anti-money laundering rules, based on an understanding of the key implications to accountants of these requirements.

Quiz questions

1	G.1
The main difference between IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures* is that (choose one):	
A	S1 focuses on general sustainability risks, while S2 also considers opportunities
B	S1 provides a baseline and companies are expected to transition to reporting S2 related risks in subsequent periods
C	S1 refers to reporting against targets adopted by the company, whereas the S2 targets are agreed internationally
D	S1 covers risks to the sustainability of the business in general, while S2 covers risks arising from climate change

2	G.1
Climate related scenario analysis is described in IFRS S2 as (choose one):	
A	A standardised method for analysing risk that can be tailored to specific industries
B	A specific set of inputs and assumptions that companies in different industries should apply
C	An analytical tool that should be used by companies registered on a US stock exchange
D	A generalised approach that should be followed, using inputs and assumptions that meet the company's circumstances

3	G.1
Understanding Anti Money Laundering procedures is important for accountants because (choose one):	
A	They may be consulted by banks for advice on identifying money laundering
B	They are often the persons best placed to identify a money laundering transaction
C	IFAC requires all member accountants to be up to date with international money laundering rules
D	They may work for a company which is subject to anti money laundering rules

Unit H: Digital Technologies

Learning outcomes

H.1	Use of digital technologies to access, analyse and present relevant information effectively and efficiently

Introduction to Unit H

This final part of the syllabus builds on the material in Financial Reporting that introduced some key aspects of technological innovation in the field of accounting and reporting. The initial focus is on digital reporting as defined by the IFRS foundation, specifically the requirements for reports to computer-readable through the use of new digital tools. It then looks in more detail at one of these key tools, which is the application of taxonomies to financial statement captions. Finally, it turns to three of the most widely discussed new technologies which have the potential to impact on the accounting profession, namely cloud accounting, blockchain and artificial intelligence.

H.1 Use of digital technologies to access, analyse and present relevant information effectively and efficiently

1.1 Digital Technology

You may be aware that the core tool of the accountant's profession, double entry bookkeeping, was invented in Italy around the 14th Century and remains in use essentially unchanged from that time. While this core technique has hardly changed, the day job of a contemporary accountant would be almost unrecognisable to a Renaissance Italian. The main reason it would be unrecognisable is the global transition from paper ledgers to electronic records, which have furnished accountants with a capacity to collect and analyse data that would hitherto have been almost unimaginable. As you learned in Financial Reporting, recent technological developments present an array of opportunities and threats to the professional accountant, from increased speed and accuracy of processing allowing much more granular analysis of data, to new and evolving risks around cybersecurity and fraud. In this Unit we will be expanding on the material introduced in Financial Reporting to discuss in more depth the features of some key contemporary innovations as well as the benefits and risks that can arise from their use in an accounting environment.

The main areas covered in this Unit are as follows:

1. Digital Reporting
2. The application of the IFRS Accounting Taxonomy
3. Key Innovations: Cloud, Blockchain and AI

1.2 Digital Reporting

This area refers to the use of digital technology to generate financial reports, as well as the underlying processes to generate, classify and analyse financial and relevant non-financial data. According to the IFRS Foundation, digital financial reporting allows investors and other users of financial reports to efficiently search, extract and compare companies' accounting and sustainability-related financial disclosures.

Financial Reporting broke this down further by identifying the following general benefits of using digital technology in accounting:

Automation	Where financial reporting involves repeated actions, these may be automated rather than requiring human intervention.
Speed	As technology becomes more sophisticated and more automated, there is potential for preparing financial statements and delivering them to users more quickly.
Accuracy	Less human intervention may lead to more accuracy, especially in repeated actions.
Volume	'Big data' is becoming a more necessary part of modern commercial activity, and this can impact on financial reporting. Big data is extremely large and diverse collections of data that continue to grow over time and are too large or complex to be dealt with by traditional data-processing application software. Also, large companies with complex structures require large volumes of transactions and adjustments in preparing financial statements.
Flexibility	At the one end of the spectrum, delivering financial statements on paper, or in a 'fixed' format such as a pdf document, does not enable users to adapt the information easily, whereas digitised forms of financial information may provide more opportunities.
Comparability	Use of the same technology over time and across different organisations may enhance the consistency of information (in terms of content and presentation) and thus increase the ease of making comparisons. See also the use of 'tags' in relation to the IFRS Accounting Taxonomy, below.
Interrogation	Where financial statements are provided in a flexible format (e.g. via spreadsheet, or with XBRL), the user is more able to carry out detailed analysis of the information.

The key point about digitisation is that it theoretically enables more rapid and accurate production of financial information, which in turn enables investors to conduct meaningful comparisons between companies, or to compare one company over several periods.

As noted above, although financial reports in a PDF format are visually and contextually understandable to humans, this format makes it difficult for users of financial reports to efficiently extract, compare and analyse company information. A digital financial report is a financial report in a computer-readable, structured data format such as XBRL, which allows investors to compare and analyse information efficiently. Companies enable this analysis by releasing their financial data in a computer readable format that investors can break down and cross reference to answer specific questions about company performance more easily and with greater precision than is provided by subjecting financial statements to standard ratio analysis. According to the IFRS, digital financial reporting thereby enables improved capital market transparency and efficiency and this in turn promotes capital formation, allowing companies to raise capital at a lower cost. This opens up greater opportunities for investment, which leads to economic growth and development. Research suggests that the introduction of mandatory digital financial reporting requirements in the US, EU and other jurisdictions, has led to economic and other benefits for a multitude of stakeholders.

In an April 2024 report titled, Digital Financial Reporting: Facilitating digital comparability and analysis of financial reports, the IFRS identifies the following benefits that digital reporting provides to three key IFRS stakeholders:

Stakeholder	Benefit
Investors	· Automated data collection and reduced search costs · More efficient information processing · Reduced information asymmetry · Expanded population of possible global investment targets
Companies	· Increased analyst coverage and access to capital, including foreign investment, fostering a broad and stable investor base · More efficient and accurate benchmarking and peer analysis · Reduced burden of submitting the same information to multiple organisations or government agencies
Regulators	· Increased capital formation · More efficient market oversight and enforcement reviews · Automated validation checks and technology-driven monitoring · Improved data sharing between regulators and government agencies

https://www.ifrs.org/content/dam/ifrs/standards/taxonomy/digital-financial-reporting/digitalreportingarticle-april2024.pdf

It should be noted that these benefits apply primarily to publicly listed companies, who are required to produce and make public large amounts of structured data as part of their legal responsibilities. These data sets, along with the financial statements and quarterly reports etc., provide the information population that digital systems can collate and analyse.

1.3 The application of the IFRS Accounting Taxonomy

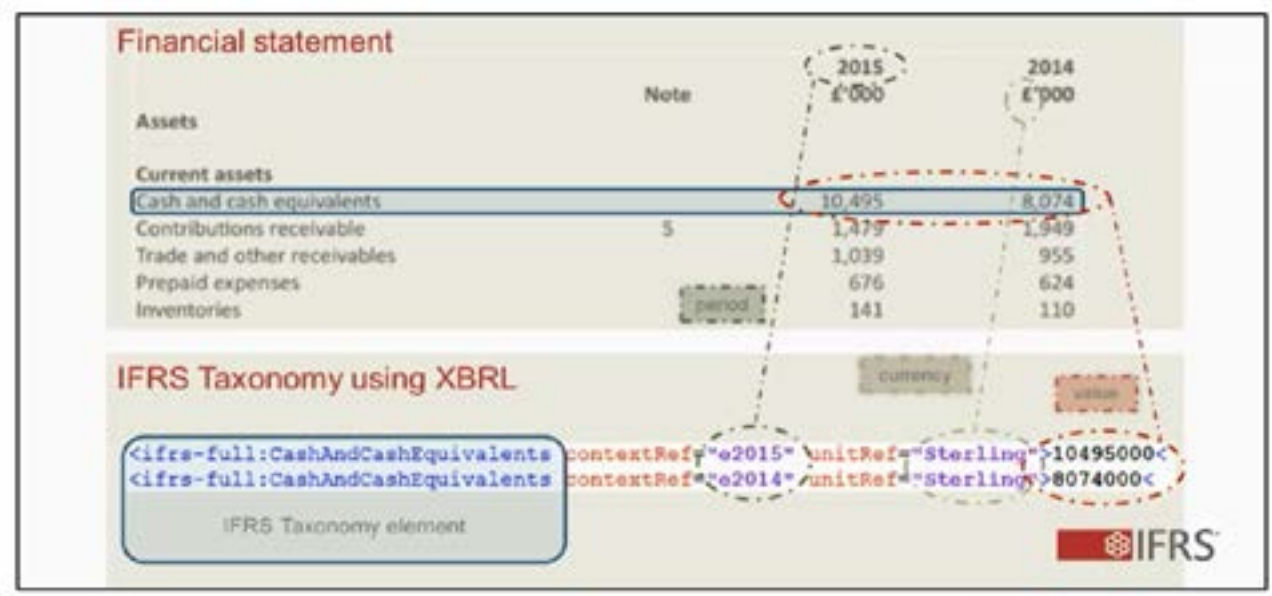
As well as being produced in a computer readable format, digital financial reports also need a way to standardise the presentation of financial information, so that the computer can read across different financial statements and compare items which are similar, irrespective of the precise caption used. In Financial Reporting you saw the Example of two companies, one of which uses "Bank" and rounds the numbers to the nearest million, and the other uses "Cash and Bank" and rounds to the nearest thousand. These types of disclosure differences are common and they make comparison by manual methods cumbersome and time consuming.

Digital financial reports can use "tags" to indicate the substance of a particular line item by referencing that item to the relevant standard. These tags are developed using a taxonomy that is produced by accounting authorities based on the standards the authority issues (e.g. IFRS Accounting Taxonomy and the US GAAP Financial Reporting Taxonomy). A taxonomy is a structure for classifying things based on their common features and typically comprises both a scheme of classes and the specific allocation of things to those classes. A chart of accounts is a taxonomy that you are familiar with, dividing financial information into the elements (income, expenditure, assets etc.) and then into the sub-classes of sales revenue, cost of sales, PPE and inventory and so on.

Once a caption has been tagged using the taxonomy, it can be compared to other line items that have the same tag, irrespective of the actual captions in use. Computerised systems will also be capable of adjusting information to take account of other tags, such as the financial year to which information refers, and the degree of rounding applied to an element.

The IFRS Foundation provides a very helpful illustration of how tags work in a presentation available online ("Taxonomy doesn't have to be taxing") ***https://api.irp2.ovp.kaltura.com/html5/html5lib/v2.101/mwEmbedFrame.php/p/179/uiconf_id/23451779/entry_id/0_hzdys3i9?wid=_179&iframeembed=true&playerId=kaltura_player***

A screen shot was used to capture the Example below:



As you can see from the XBRL taxonomy at the bottom of the Example, the code here is looking for the tag "cash and cash equivalents". Additional arguments can extract the

financial reporting period and the currency in use, as well as the values reported. If this is a parent company, and one of its subsidiaries uses the caption "bank and cash," it will be possible to extract the correct figure if it uses the same tag.

There are two IFRS digital taxonomies, the IFRS Accounting Taxonomy and the IFRS Sustainability Disclosure Taxonomy.

According to the IFRS Foundation, the IFRS digital taxonomies:

- Are derived from IFRS Standards and reflect the requirements in the Standards and the accompanying materials.
- Contain common practice elements that allow companies to tag information commonly provided in financial reports prepared in accordance with IFRS Standards that is not specifically required by IFRS Standards.
- Can be used with XBRL, ixbrl and other digital reporting formats.
- Are regularly updated to reflect changes in IFRS Standards.
- Are unrelated to the 'green' taxonomies used for assessing or categorising the sustainability rating or attributes of a company or product, or the sustainability attributes of economic activities.

Tagging requires the use of specialised software to assign elements/tags from the relevant digital taxonomy to information in a company's financial report. This process produces a digital financial report in a structured data format (such as XBRL). Several tagging software solutions are available. The costs associated with preparing digital financial reports vary depending on factors such as the complexity of the company's reports and its approach to tagging. The costs can be relatively modest and typically reduce significantly after the first year.

Companies typically use one of two approaches to tagging their financial reports:

- An integrated approach—tagging is built into a company's financial reporting management system and report design tools
- A content-first approach—the tagging process starts after a company has prepared its financial report in a pdf format. Under this approach, the tagging process is commonly outsourced to a third-party tagging agent.

Each company is ultimately responsible for the quality of its digital financial report. Therefore, even when the tagging process is outsourced, a company's digital financial report should be subject to review by management.

According to the IFRS Foundation, significant diversity currently exists in whether and how financial reports become computer-readable, the quality of digital data available and the accessibility of digital financial reports. Consequently, investors often cannot digitally extract and compare financial report data from various jurisdictions—and often within the same jurisdiction. In other words, even in relatively advanced countries like the USA, the production of reports in computer readable format using tags is not universal, and comparisons of companies that operate in different countries are hampered by uneven adoption. For users of financial reports to realise the full benefits, digital financial reports should:

- Be a complete and accurate representation of reported information
- Be structured in a digitally comparable format
- Be publicly available at the same time as reported information

- Be centrally accessible in an easy-to-use format

1.4 Key Innovations: Cloud, Blockchain and AI

In addition to digital reporting, a number of other technological innovations are expected to have a significant impact on the accounting profession. We will look at three of the most widely known and consider some of their features as well as their key advantages and disadvantage: cloud computing, Blockchain, and AI, or artificial intelligence. Cloud accounting, also known as online accounting or web-based accounting, refers to the use of internet-based software and storage solutions to manage and process financial data. Unlike traditional accounting, which relies on local servers and physical infrastructure, cloud accounting operates on remote servers hosted by third-party providers. While this may appear similar to the "thin-client" model of network management, these networks were normally hosted internally, which requires the company to manage everything themselves. Cloud accounting takes advantage of higher internet speeds, more advanced software and the connection options provided by digital devices like cell phones, to enable servers to be hosted by third parties, transferring the costs and expertise required to dedicated companies, such as Google Cloud, Microsoft Azure and Amazon Web Services. The following opportunities and risks relating to use of the cloud in accounting can be identified:

Opportunities	Risks
Up to date information for decision making	Internet reliability
Improved collaboration	Accessibility of sensitive information
Integration of systems	Data ownership and control
Reduced upfront costs	
Scalability	
Data management and security expertise	

On traditional company networks data is stored locally and this can make it a challenge to access and update information in real-time, especially for businesses with multiple locations or remote teams. In contrast, cloud accounting allows users to access their financial information easily, using any device with an internet connection. This means that decision making can be informed by the most up to date information across the business, and not necessarily that which is available at HQ.

Moreover, in traditional accounting, collaboration often involves sharing physical documents or sending files back and forth between team members or teams, leading to inefficiencies and potential errors. Cloud accounting platforms facilitate seamless collaboration, enabling teams to work concurrently on the same set of financial data. This collaborative environment promotes teamwork, transparency, and accuracy, ultimately leading to streamlined processes and improved productivity.

Furthermore, cloud accounting platforms often offer integration capabilities with other business systems such as customer relationship management (CRM) software, inventory management systems, or payment gateways. This integration eliminates the need

for manual data entry and enables the automatic flow of information across different departments and systems. Additionally, cloud accounting systems often incorporate automation features, such as automatic bank feeds and recurring transaction templates, which streamline repetitive tasks and increase operational efficiency.

Cloud accounting systems can offer more cost-effective and affordable solutions compared to traditional accounting set ups, since businesses are able to avoid upfront hardware and software costs. Instead, they pay a subscription fee based on their usage, which is often more affordable and scalable. Additionally, cloud accounting eliminates the need for businesses to invest in IT infrastructure maintenance, upgrades, or backups, as these responsibilities are handled by the cloud service provider. This cost efficiency allows businesses, particularly small and medium-sized enterprises, to allocate their financial resources strategically and invest in other areas of growth.

Whether a business experiences rapid growth or seasonal fluctuations, cloud accounting systems can easily scale up or down, eliminating the need for costly infrastructure upgrades or software installations. If a company expands its data or system requirements it can simply upgrade to a higher subscription level with the features needed, or the converse if the company needs to downsize. This scalability ensures that businesses can adapt their financial management processes to match their changing demands, without being limited by hardware or software constraints.

One of the main benefits of using third-party providers, like Google or Amazon, is their dedicated expertise in all aspects of data management and security. These providers prioritise data security and offer robust measures to protect financial information. Cloud service providers implement advanced security protocols, including data encryption, firewalls, access controls, and intrusion detection systems. This level of security is often superior to that which can be achieved with traditional accounting systems, as cloud providers have teams of cybersecurity experts focused on ensuring data privacy and protection. Additionally, cloud accounting platforms offer regular data backups, reducing the risk of data loss due to hardware failures or unforeseen events.

In terms of the risks of using the cloud for financial information management, the most obvious is perhaps the need for a reliable internet connection. Since cloud accounting operates through online servers, businesses need reliable and consistent internet access to work with and update their financial information. Unforeseen internet outages or disruptions may temporarily hinder access to the accounting system, impacting business operations. It is essential for businesses to have backup plans in place, such as alternative internet providers or mobile data options, to mitigate the impact of potential internet downtime. While Rwanda has among the best internet services in Africa, other countries both in Africa and elsewhere do not have guaranteed access to reliable internet. So, a parent company in Rwanda might confidently introduce cloud-based accounting, but it may need to think carefully before requiring subsidiaries operating in other countries to use the same system. A further consideration relates to the ability of other parties to access information that is stored in the cloud, and this can be very important since financial information is often highly sensitive. Thus, while a cloud provider might have the strongest security available, it will also present an extremely attractive target to hackers and fraudsters. In addition, information stored on physical servers a different country is potentially at risk of being caught up in an investigation of the provider by local authorities, or litigation.

Businesses should consider the issue of data ownership and control when adopting cloud accounting systems. It is crucial to ensure that the cloud service provider adheres to industry best practices, complies with relevant data protection regulations, and offers

transparent information about data handling and storage practices. Businesses can reduce these risks by:

- Assessing the physical security measures implemented at the provider's data centres to ensure the protection of their financial information.
- Understanding the terms and conditions outlined in the service agreement to determine who owns the data and what rights the business retains over its financial information.
- Ensuring the cloud provider stores data in a manner that meets local regulatory requirements, for Example laws in different countries have different rules about how long financial records need to be retained. • Assessing the processes and procedures in place for data retrieval and migration in the event of switching providers or discontinuing the service.

You were introduced briefly to Blockchain in Financial Reporting, so this section will expand on that introduction by looking at its application to accounting. Blockchain is also known as distributed ledger technology (DLT), a digital system that records asset transactions and their details in multiple locations simultaneously. Blockchains comprise blocks of interactions and transfers recorded in chronological order. These blocks can be assets of any digital kind, for Example, money, securities, land titles, information on identity, health and other personal data.

Traditional accounting maintains and stores records in a centralised location, typically in the database of an accounting software application, and these records must be retrieved for access to be provided. Blockchain, on the other hand, is accessible to all relevant parties by employing a triple-entry bookkeeping model. The third entry means all stakeholders – accountant, auditor, client, regulator – will have an identical copy of the ledger at all times, shared across a peer-to-peer network of nodes (computers) spread across multiple sites. To alter information in the ledger requires the permission of everyone involved, which means information on the blockchain can be accurately relied upon. Security is enhanced by the use of cryptography to secure information, and the use of private and public keys to authenticate users.

One of the main benefits that are cited for the use of blockchain is the ability to implement "smart contracts." A smart contract is a computer protocol that runs on top of a blockchain. It sets rules for contracts and enforces agreements once the rules are met. A smart contract for Example, may hold funds on one part of the chain that can be automatically released to the specified beneficiary once specific terms written into the blockchain contract have been satisfied.

There are three different types of blockchain that can be used for various accounting purposes:

- Public blockchain: Open to anyone and highly transparent.
- Private blockchain: Restricted access, often used within organisations.
- Consortium blockchain: Shared among a group of trusted organisations.

Probably the most famous public blockchain in Bitcoin, which adheres to the original conception of the blockchain as an open network in order to support a permissionless digital asset. The other two types of blockchain, both of which are permissioned (i.e. depend on a designated authority to approve transactions), have seen wider adoption in financial management and accounting environments. In a September 2023 blog post under the London School of Business and Finance, the following real life applications of

blockchain technology are identified:

- Supply chain management: IBM's Food Trust platform uses blockchain to trace the origin of food products, reducing foodborne illnesses by 60%.
- Digital identity verification: Estonia's e-Residency programme employs blockchain for secure digital identity verification, serving over 80,000 people globally.
- Cross-border payments: Ripple, a blockchain-based payment platform, has partnered with over 300 financial institutions to enable faster and cheaper cross-border transactions. This technology can reduce cross-border payment costs by up to 60%, according to a report by McKinsey & Company.
- Intellectual property protection: The WIPO (World Intellectual Property Organization) uses blockchain to record intellectual property rights, providing creators with immutable proof of ownership.
- Healthcare data security: MedicalChain utilises blockchain to secure and streamline medical records, ensuring patient data remains confidential and accessible to authorised personnel.

https://www.lsbf.org.uk/blog/online-learning/what-is-the-role-of-blockchain-in-accounting

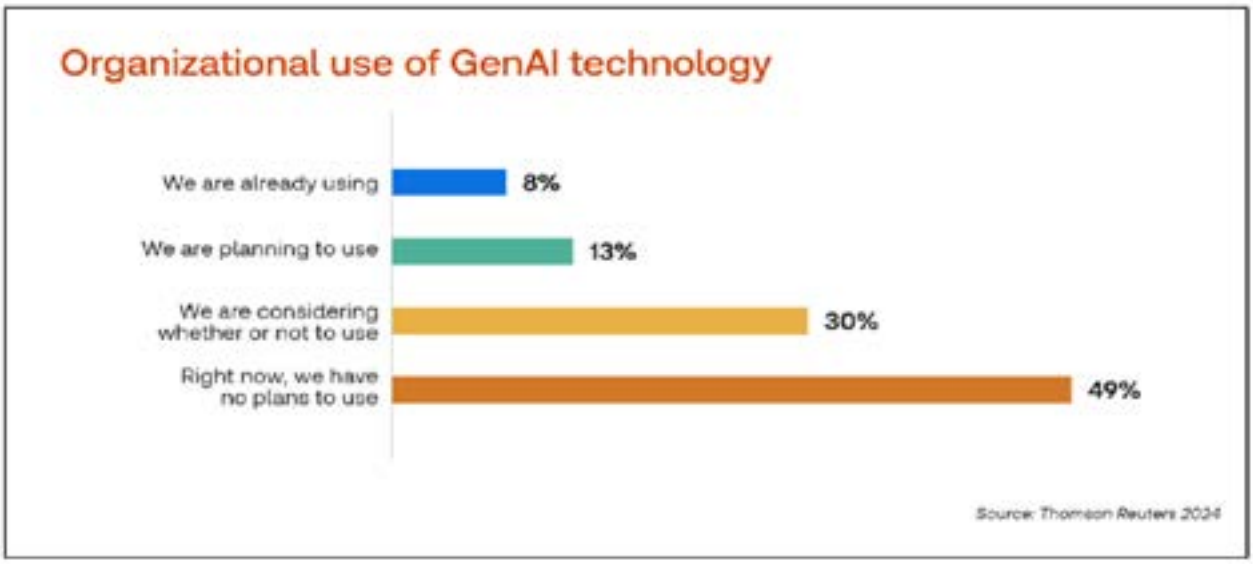
It is notable that there do not yet appear to be any widely adopted blockchain applications in financial reporting and audit, despite considerable excitement in the professional literature, and the technology first being implemented in 2008 to serve as the ledger system for Bitcoin. Indeed, blockchain related accounting websites in 2024 are still using conditional and future tenses in their depictions of how blockchain will change the world, and seem unable to provide specific measured Examples of the actual benefits achieved in a financial reporting environment. That said, it is quite likely that professional accountants beginning their careers in the 2020s will encounter blockchain, even if that is in the form of a closed system used to manage a company's inventory or financial assets. Appreciating the basic function of the blockchain is thus a useful preparation for its future impact on the accounting profession.

Unlike blockchain, Artificial Intelligence has already exhibited a number of potential use cases in accounting and financial reporting. The most compelling of these is perhaps the ability of AI to analyse massive amounts of data in real-time, opening the door to predictive analytics. This capacity allows accountants to identify trends and indicators hidden in granular data that would often be overlooked by standard analytical tools. Spotting these indicators and their implications allow accountants to offer strategic insights and future-oriented advice, increasing the value of their contribution to the business.

This capability is especially helpful in fraud detection and financial analysis, where precision is crucial. AI-powered tools can also simplify tax preparation and compliance by ensuring adherence to the latest regulations and standards.

That said, a blog post from Thomson Reuters Tax and Accounting from June 2024 discusses a survey of accounting firm plans in relation to AI which indicates that enthusiasm for AI is not yet widespread:

https://tax.thomsonreuters.com/blog/how-do-different-accounting-firms-use-ai/



This somewhat negative attitude does not reflect the views of the Big 4 accounting firms, all of which have devoted considerable efforts to utilise AI in their businesses. The blog post provides Examples for each of these firms:

- **Document review:** Deloitte has internally developed an automated document review platform. The tool uses cognitive technologies and fits into their practitioners' existing workflows, allowing them to evaluate an entire population of contracts to find key information.
- **Auditing:** EY is embedding AI technology into its audit process. They are using AI to analyze and extract data from unstructured data, such as contracts, and analyze large data sets to help respond to the risks of material misstatement due to fraud.
- **IT:** In-house teams at PwC have developed customized software applications for employees that synthesize data, complete, and review code, generate documentation, and more. They have seen 20% to 50% productivity gains in their development processes because of GenAI. Additionally, PwC professionals have access to an enterprise version of ChatGPT-4o for themselves and their clients.
- **Client solutions**: KPMG's Trusted AI framework helps their member firms' clients design, build, deploy, and use AI tech solutions in a responsible and ethical manner, building loyalty and partnerships.

Another way that companies are already benefiting from using AI is to assist with tagging their financial reports, using the accounting taxonomies we discussed above. Human involvement and oversight, however, continues to be necessary, especially when tagging decisions require greater levels of judgement.

Investors and other users of financial reports are also benefiting from AI-assisted tools to collect and structure data, generate insights and enhance the overall efficiency of users' analysis. It should be apparent that, as well as adding tags, AI can be particularly useful in conducting the type of deep analysis of granular data that digital financial reports enable.

The quality of AI-generated output is dependent on the quality and structure of the underlying data. In the absence of structured data provided by digital financial reports,

AI has to structure information in financial reports by, in effect, making educated guesses, which becomes more problematic if:

- No history of structured data is available for AI models to learn from—for Example, when standards are amended or companies provide new information
- Custom AI models are being trained in isolation, producing varied outputs.

The risk of AI incorrectly structuring and identifying information prepared in accordance with IFRS Standards is mitigated by:

- The structure provided by the IFRS digital taxonomies, which are readily available and regularly updated to reflect changes in IFRS Standards
- Companies retaining control over their tagging decisions, rather than AI making educated guesses.

Digital financial reports provide a solid foundation for investors and other users of financial reports to focus on building AI models that generate high-quality output. Without that foundation, the costs of building AI models to gather and structure data can be high, and the accuracy of such models can vary.

While AI can automate routine tasks, that does not mean that accountants face imminent obsolescence. Rather, AI will require accountants to move away from routine bookkeeping and towards more strategic, analytical, and advisory functions. Accountants who embrace AI and learn to leverage its capabilities can potentially increase their value by guiding the application of AI and interpreting its results. Current iterations of AI lack the capacity to apply professional judgement, or ethics, and its outputs need to be mediated. So, instead of seeing AI as a threat, accountants should view it as an opportunity for professional growth and development.

Summary of Unit H and key learning outcomes

In this unit, we looked at the following learning outcome:

Learning outcome	
Discuss the application of digital technologies in accessing and analysing organisational reporting information, and in presenting this information as effectively as possible to stakeholders.	You should now be able to discuss digital reporting and the use of the IFRS taxonomies in enabling better analysis of financial information, as well as some of the main features of three critical innovations in technology: cloud accounting, blockchain and artificial intelligence.

Quiz questions

1	H.1
Which one of the following is not identified as a benefit of using digital technology in financial reporting:	
A	More granular financial information improves potential investors' understanding of the company
B	Potential investors are able to access real time information about a company
C	Companies can more easily assess their comparative performance against other listed companies
D	Companies can use digital information to fulfil different types of disclosure requirements

2	H.1
The application of tags to digital reports requires (choose one):	
A	Specialised knowledge of the XBRL structured data format
B	The use of a third-party tagging consultant
C	The application of the appropriate IFRS taxonomy to the report contents
D	The integration of the appropriate IFRS taxonomy into the accounting process

3	H.1
Companies that use cloud-based accounting should **ensure** that the service provider (choose one):	
A	Has suitable data access restrictions
B	Is located in the same country
C	Applies IFRS in its accounting software
D	Recognises local requirements for financial reporting

4	H.1
AI may present a threat to accountants because (choose one):	
A	It can assign tags to financial captions thus eliminating the need for accountants to prepare financial statements
B	It is able to predict future trends based on analysis of granular data
C	It can eliminate the need for many basic bookkeeping processes
D	Instant access to financial records eliminates the need for audit

Summary of Module and key learning

Throughout this module, we have explored a comprehensive array of advanced topics in financial reporting. We began with professional ethics, understanding why ethical behavior and compliance are essential for accountants and financial professionals. Applying ethical standards to every activity and behaviour helps safeguard the credibility of financial information and foster trust among stakeholders.

We then examined the regulatory frameworks that governs financial reporting, delving into the rules and guidelines for preparing financial statements in both the private and public sectors. By differentiating between these sectors, you should have gained insight into how regulations are tailored to suit various organizational needs and oversight requirements.

We continued the module with the development and presentation of financial and non-financial information. In this unit we learned how to prepare and disclose financial details, with special emphasis on public sector disclosure, emphasising the growing importance of non-financial information, such as sustainability and social responsibility data. Understanding both forms of reporting should build your appreciation of the full scope of organisational disclosures.

A significant portion of the module is comprised by Unit D focusing on specific financial reporting issues. In this unit we investigated the classification and measurement of assets, liabilities, financial instruments, employee rewards, revenue, income, and fair value measurement. Special attention was given to industry-specific reporting in the private sector, reporting for small and medium-sized entities and public sector accounting.

We also addressed financial statements of group entities, including business combinations, consolidations, associates, joint arrangements, changes in group structures, international operations, and public sector combinations. This part of the module should have deepened your understanding of how complex organisations report their consolidated results.

In developing analytical skills, we learned how to explore and interpret both financial and non-financial information, including financial statements from both private and public-sector organisations. These tools enable finance professionals to draw meaningful conclusions and provide valuable insights for decision-making.

The module included a discussion of current developments in financial reporting. In this we covered contemporary issues and examined solutions, which are designed to equip you to remain informed about continuously evolving standards and practices.

Finally, we discovered how digital technologies can and will transform financial reporting. The evolution of digital tools will improve the access, analysis, and presentation of information, increasing efficiency and effectiveness in reporting.

Quiz answers

Unit A

Scenario:

You are a professional accountant in the accounting services function of a large audit and accounting firm who has recently applied for a manager's position. Your team has been assisting a large audit client of the firm with resolving issues relating to bank reconciliations. During the course of your work, you have identified that historic bank balances have been mis-stated due to a number of significant systematic weaknesses in internal controls. The financial statements which include these mis-statements were audited by your firm and do not identify any issues with bank balances or internal controls.

Due to the significance of this client, the managing partner of the firm is the lead engagement partner.

Solution:

When answering an ethics question, you should first identify the fundamental principle(s) and the corresponding threat(s), before going on to consider appropriate safeguards. In this scenario you are exposed to a potential conflict of interest between your own desire to be promoted and your obligation to notify the managing partner that the client's financial statements have been mis-stated. This threat to your objectivity as well as integrity and professional competence and due care cannot be reduced to an acceptable level without safeguards being applied. Since you work for a large firm, you can reasonably assume that most of the institutional safeguards are in place, and that the managing partner will be fully conversant with the ethical issues involved. In addition, the firm would be likely to have a designated ethics partner to whom you could apply for advice. The scenario does not identify any constraints on these safeguards (such as the firm struggling to retain clients, or having a lax attitude to ethics), so the best course would be to use such internal safeguards that exist internally in the firm. In the event that the managing partner refuses to take action over the mis-statements, the next available recourse would be to seek advice anonymously, perhaps through engaging with the ICPAR helpdesk. The main outcome to avoid would be keeping silent, or adjusting the bank balance figures in your working papers to match the audited figures.

Unit B

Answers

Question	Answer
1	C
2	A
3	D
4	C
5	B
6	D

Explanations

1	Unit B
The new ISSB Sustainability Standards can be best described as:	
A	Mandatory for all companies using IFRS
B	An option available for companies using IFRS to adopt
C	An essential component of accountability
D	Mandatory for publicly traded companies using IFRS

1	Feedback
A	Incorrect – The standards are an essential component of accountability and are not mandatory
B	Incorrect – The standards are viewed by IASB as an essential component of accountability and not an optional extra
C	Correct
D	Incorrect – The standards are not mandatory for IFRS compliance but may be made mandatory by listing or other requirements in specific jurisdictions.

2	Unit B
The main benefit of using a principles-based approach to accounting is (choose one):	
A	The principles can be applied in a variety of operating settings
B	A principles-based approach reduces ambiguity
C	The principles are easier for accountants to properly apply than a set of complex rules
D	The principles can be applied to a wider range of accounting activity

2	Feedback
A	Correct – A principles-based approach is highly flexible
B	Incorrect – A rules-based approach is more likely to reduce ambiguity The principles can be applied in a variety of operating settings
C	Incorrect – Rules are arguably easier to follow than principles
D	Incorrect – Principles are arguably easier to apply broadly then highly specific rules

3	Unit B
Which one of the following statements correctly describes the process for developing IPSAS standards:	
A	Consultation papers are published for each ED issued, but not for RPGs
B	The maximum period allowed for comment on an ED or RPG is 120 days
C	The PIC consults with stakeholders worldwide before it develops the IPSASB strategy
D	EDs are published to allow stakeholders the opportunity to comment before formal standards are issued

3	Feedback
A	Incorrect – Consultation papers are only published for complex issues

B	Incorrect – There is no maximum period for comment
C	Incorrect – The PIC does not develop the IPSASB strategy
D	Correct

4	**Unit B**
The IPSASB interacts with other standard setting bodies in order to (choose one):	
A	Maximise the acceptability of IPSAS standards
B	Reduce the need to prepare IPSAS where other standards exist
C	Develop a consensus around issues common to different frameworks
D	Align IPSAS standards with statistical reporting frameworks

4	**Feedback**
A	Incorrect – Maximising acceptability is not a stated objective of consultation.
B	Incorrect – Consultation is not intended to reduce the IPSASB workload by adopting other standards.
C	Correct
D	Incorrect – While alignment with statistical frameworks is important, equally so is alignment with IFRS.

5	**Unit B**
Which one of the following statements about GPFRs is correct (choose one):	
A	GPFRs comprise financial statements and a budget out-turn
B	The scope of GPFRs is determined by users' needs
C	The users of GPFRs comprise tax payers and service recipients
D	GPFRs are intended to meet specific users' needs

5	Feedback
A	Incorrect – The scope of GPFRs is not prescriptive although they will usually contain these reports
B	Correct
C	Incorrect – The users of GPFRs include resource providers, who may be external (and non tax-paying) donors.
D	Incorrect – GPFRs are not directed to specific users.

6	Unit B
IPSASB includes materiality as a constraint in financial reporting because (choose one):	
A	Public sector accounting is more complex than private sector accounting
B	Public sector entities have limited resources to spend on financial accounting and reporting
C	Public sector accountants are less competent than private sector accountants
D	The scope of GPFRs is wider and this may result in normally material items being less important

6	Feedback
A	Incorrect – There is no intrinsic difference in complexity between private and public sector, although the former tends to be more complex.
B	Incorrect – While IPSAS do in same cases allow cost benefit to be weighed in determining accounting policies, this has no bearing on materiality.
C	Incorrect – While many public sector finance roles are filled by non-accountants, both the private and public sector employ the same chartered accountants in key roles.
D	Correct

Unit C

Answers

Question	Answer
1	D
2	B
3	A
4	B
5	C
6	C
7	D

Explanations

1	C.1
If a GPI for a country shows the following rates, what is the conversion factor at 31 Dec 20X5 for items acquired in 20X3? 20X3 – 90 20X4 – 160 20X5 – 240	
	1.77
	0.37
	1.50
	2.66

1	Feedback
A	Incorrect – 240/90 = 2.66
B	Incorrect – 240/90 = 2.66
C	Incorrect – 240/90 = 2.66
D	Correct 240/90 = 2.66

2	C.1
If the company illustrated above reported quarterly, what would be the correct comparator for the Statement of Profit or Loss for quarter 3 20X5 (choose one):	
A	31 December 20X4
B	30 September 20X4
C	30 June 20X4
D	31 March 20X4

2	Feedback
A	Incorrect – Quarter 3 ends on 30 September
B	Correct
C	Incorrect – Quarter 3 ends on 30 September
D	Incorrect – Quarter 3 ends on 30 September

3	C.1
Which one of the following companies is not normally a related party to Company A, under IAS 24?	
	Company Z's audit committee is chaired by Company A's finance director
	Company P operates Company A's defined benefit pension plan
	Company L is owned by the CEO of Company A
	Company J is a joint venture between Company A and Company T

3	Feedback
A	Correct
B	Incorrect – This role does not make company P a related party
C	Incorrect – This role does not make company L a related party
D	Incorrect – This role does not make company J a related party

4	C.1
Which one of the following statements is false in respect of the application of IFRS 8?	
	Companies should report segment depreciation for relevant assets
	Operating segments with 10% of the company's assets are reporting segments
	Amounts reported under segments should be reconciled to the financial statements
	Reporting segments must contribute at least 75% of the company's total revenue

4	Feedback
A	Incorrect – Depreciation is required for relevant segment assetss
B	Correct – A reporting segment should have 10 per cent or more of the combined assets of all operating segments or meet the revenue or loss test under IFRS 8.
C	Incorrect – Total figures for segments should be reconciled to the financial statements
D	Incorrect – Reporting segments should equal 75% or more of revenue.

5	C.2
Which one of the government owned entities below should be categorised as part of the public non-financial corporation sector?	
	Ministry of Defence
	The Central Bank
	The Postal Service
	The Customs Agency

5	Feedback
A	Incorrect – This is a part of central government, not the public corporation.
B	Incorrect – This is a public financial corporation
C	Correct – The postal service is a public non-financial corporation
D	Incorrect – This is a public financial corporation

6	C.3
In terms of the information to include in management commentary, which of the following is not a requirement of the IFRS Practice Statement 1 (choose one):	
A	Information should be forward looking
B	Information should be consistent with the conceptual framework
C	Information should be incorporated into the financial statements
D	Information should be relevant to management

6	Feedback
A	Incorrect – Management commentary should be forward looking
B	Incorrect –Management commentary should be consistent with the conceptual framework
C	Correct Management commentary should not be incorporated into the financial statements but separated from them.
D	Incorrect – Management commentary should be relevant to management.

7	C.3
Which of the capitals should a company's brand value be categorised under (choose one):	
A	Financial capital
B	Intellectual capital
C	Human capital
D	Social capital

7	Feedback
A	Incorrect – Brands are an aspect of social capital
B	Incorrect – Brands are an aspect of social capital
C	Incorrect – Brands are an aspect of social capital
D	Correct - Brands are an aspect of social capital

Unit D

Question 1 Capitalisation Costs (D.1)

A company is building a factory to produce widgets. The following related costs have been incurred during construction to date:

Land survey and environmental assessment	250,000
Construction materials	2,500,000
Transport of construction materials	300,000
Consulting engineer's fees	100,000
Project management costs incurred by Human Resources	25,000
Wages of construction labourers	120,000
Interest due on loan of 1 000 000, half of which has been used to fund the new factory and half for other purposes.	50,000
TOTAL	3,345,000

What amount should be capitalised?

Solution

With the exception of the costs incurred by Human Resources and half the loan amount, all the expenses listed above are directly attributable to bringing the factory into productive use. The amount to be capitalised is therefore 3,345,000 – 25,000 – 25,000 = **3,295,000.**

Question 2 Component Accounting (D.1)

Company B runs an airline and has just acquired a new aircraft for 50 million. Company B's aircraft comprises three physical components: an airframe valued at 25 million with a 20-year useful life, engines valued at 20 million with a 10-year useful life, and interior fittings valued at 5m with a useful life of 5 years. If it applies component accounting to the aircraft, it will calculate separate depreciation charges for each component by dividing its cost by its useful life and adding these together for the annual total. If it does not apply component accounting, it will instead divide the total cost by the useful life of the longest-lived component.

What is the resulting depreciation charge when correctly applying component accounting?

Solution

The resulting depreciation charge arising from allocation of the 50 million purchase price to the three components of the aircraft would be as follows:

Component	Cost	Useful Life (years)	Annual Depreciation
Airframe	25m	20	1.25m
Engines	20m	10	2m
Interior fittings	5m	5	1m
TOTAL	**50m**		**4.25m**
Depreciation – no component			(2.5m)
Understated depreciation			1.75m

The table demonstrates that depreciating the entire asset cost over the longest useful life of its components results in a significantly lower depreciation charge to the company (2.5m instead of 4.25m). Without component accounting, however, the financial statements will fail to reflect the full costs that will be incurred during the aircraft's life to maintain its productivity.

Question 3 Calculating a revaluation (D.1)

At 31 December 20X4 Company B owned a building that had cost 750,000 10 years ago. It has depreciated the building on a straight-line basis with a useful life of 50 years.

On 1 January 20X5 a revaluation to 1,000,000 was recognised. At this date the building had a remaining useful life of 40 years.

The company's policy is to eliminate all previously recognised accumulated depreciation upon revaluation.

What are the correct journal entries for the recalculation?

Solution

To enter the revaluation into the accounts, we need to identify how much the asset has been re-valued by. This is determined by taking the difference between the new value of the asset and the previous net book value. This amount will be credited to the revaluation reserve.

The net book value before revaluation for the asset, as the asset will have been depreciated by ten years at this point, will be:

750,000 – 150,000* = 600,000

*(750,000/50 = 15,000 x 10 years = 150,000)

The new asset valuation is 1,000,000. This means the asset has been re-valued by 1,000,000 – 600,000 = 400,000. The double entry in the accounts to record the revaluation will be:

Dr	Buildings	250,000	
	(to increase from 750,000 to 1,000,000)		
Dr	Buildings accumulated depreciation	150,000	
	(to remove previous depreciation and increase net book value to new valuation)		
Cr	Other Comprehensive Income		400,000

Henceforth the depreciation charge for the building will be based on the new value divided over the remaining useful life: 1,000,000/40 = 25,000 per annum.

Question 4 Building Held for Sale (D.1)

Company A owns a building which it has used for many years as a factory. On 1 January 20X4 the building had a carrying value of 15 million with an estimated useful economic life of 15 years. Company A uses the cost model under IAS 16 to account for buildings.

On 1 April 20X4 Company A commenced operations in a new building, and the old one was placed on the market as it was no longer being used. The estimated proceeds of sale were 13 million, less selling costs of 0.2 million. It was seen as highly probable at that date that the building would sell at that price.

By year end, 31 December 20X4, the building remained unsold, so Company A reduced the asking price to 11 million. The estimate of selling costs remained the same. The directors of Company A believed at that date it was highly probable the sale would occur within 12 months at the lower price.

Explain how the old building should be accounted for by Company A for the year ended 31 December 20X4.

Solution

The building qualifies for transfer to "held for sale" on 1 April 20X4 as the two conditions were met at that date:

- It was available for immediate sale in its present condition at the date classification to "held for sale" is made; and
- The sale was considered highly probable.

The carrying value on 1 April 20X4 was 15 million less 3 month's depreciation (15m * 1/15 * 3/12) of 0.25 million. Therefore, the carrying value was 14.75 million.

The "fair value less costs to sell" on 1 April 20X4 was 12.8 million (13m – 0.2m). Therefore, the initial value to be assigned to the non-current asset held for sale is 12.8 million (the lower of (1) carrying value at date of transfer and (2) "fair value less costs to sell").

The loss in value of 1.95 million (14.75m – 12.8m) is taken to profit or loss for the year. No depreciation is charged from 1 April 20X4.

At 31 December 20X4, the next reporting date, the asset has not been sold. The applicability of the conditions is reviewed, and the fair value less costs to sell is also reviewed. Based on

the failure to sell the asset, the price was reduced. The conditions are still met in that: 1. It is still available for immediate sale in its present condition; and 2. The sale is still considered highly probable.

Therefore, the classification continues to be "held for sale", but the asset's carrying amount is reduced to the revised "fair value less costs to sell" of 10.8 million (11m – 0.2m). The further reduction in value of 2 million (12.8m – 10.8m) is taken to profit or loss for year ended 31 December 20X4.

Question 5 PPE Disclosure Note (D.1)

The following entries have been extracted from Company D's trial balance at 31 December 20X5:

	Dr	Cr
Land and Buildings – at previous revaluation	118,000	
Plant and Machinery – at cost	76,350	
Accumulated depreciation: buildings (at 1 Jan 20X5)		24,500
Accumulated depreciation: plant and machinery (at 1 Jan 20X5)		15,400

The following additional information is available for non-current assets:

1. Land is valued at 20 000 and is considered to have an infinite useful economic life.
2. Buildings are revalued regularly in line with IAS 16. They have been valued at 105,000 as at 31 December 20X5. Depreciation is to be charged based on the year-end value.
3. Buildings are depreciated on a straight-line basis over their estimated useful economic life. At 1 January 20X5 their useful economic life was estimated to be 20 years.
4. Plant and machinery with original cost of 15,000 was disposed of during 20X5. Accumulated depreciation on this asset at 1 January 20X5 was 7,500. The asset was sold for 9,000. No entries have been made yet in respect of these adjustments.
5. Plant and machinery is depreciated using the reducing balance method at 15%.
6. Assets are not depreciated in the year of disposal.

Prepare the IAS 16 disclosure note for tangible non-current assets.

Solution

	Land	Building	Plant & Machinery	Total
Cost/valuation				
Opening Balance	20 000	98 000	76 350	194 350
Disposal			(15 000)	(15 000)
Addition				0
Revaluation		7 000		7 000
Closing Balance	20 000	105 000	61 350	186 350
Accumulated Depreciation				
Opening Balance		24 500	15 400	39 900
Disposal			(7 500)	(7 500)
Revaluation		(24 500)		(24 500)
Charge for the year		5 250	8 018	13 268
Closing Balance		5 250	15 918	21 168
Carrying Amount 1 Jan 20X5	20 000	73 500	60 950	154 450
Carrying Amount 31 Dec 20X5	20 000	99 750	45 432	165 182

Working for Building Depreciation:

	Before	Revaluation	Difference
Cost (118 000 – 20 000)	98 000	105 000	7 000
Accumulated Depreciation	(24 500)	0	24 500
Carrying Amount	73 500	105 000	31 500

The depreciation charge for 20X5 will be based on the new revalued amount depreciated over the remaining 20-year life of the building: 105 000/20 = 5 250

Working for Plant & Machinery Disposal:

Cost	15 000
Accumulated Depreciation	(7 500)
Carrying Amount	7 500
Sales Proceeds	9 000
Gain on Disposal	1 500

The depreciation charge for 20X5 will be based on the new carrying amount, depreciated using the reducing balance method: (61 350 – (15 400 – 7 500)) x 15% = 8 018. The gain on disposal will be reported on the profit and loss as a gain arising from asset disposal and not as revenue.

Question 6 Intellectual property (D.1)

Company A is undertaking a review of the intellectual property it has acquired as a result of it purchasing Company B. The accountants have accumulated all the information pertaining to the costs of the following items:

1. The Company B newsletter, distributed monthly for free to credit customers informing them of market and product developments
2. A patent with 10 years remaining which covers Company B's main product
3. Company B's self-developed customer management system
4. The database of Company B's customers

Which of the above listed items would be accounted for under IAS 38?

Solution

Assuming all the items meet the core requirements for assets (past event, measurable benefit), Items 2, 3 and 4 qualify as intangible assets, while item 1 does not. Items 2 and 3 would fall under IAS 38 whether they were developed by Company A or acquired from Company B, while item 4 qualifies as an intangible asset because it was acquired, in other words its value is measurable as a component of the purchase price.

Question 7 Capitalisation of expenses (D.1)

Company C is developing a new line of pharmaceuticals and have spent 2m up to 1 January 20X5. On 1 January 20X5 following promising results from the trials, the board gave approval to fully fund the rest of the project and spent a further 1m to 1 April 20X5. On 1 April 20X5 problems were discovered in the trials and approval was not given from the medical regulator for use of the pharmaceuticals.

Company C then spent an additional 1m to 1 July 20X5 to meet the regulator's objections, at which point approval was given. From 1 July 20X5 to 1 October 20X5 Company C spent a final 1.5m putting the product into the final finished stage of development. The new pharmaceuticals are expected to generate revenues in excess of 20m and have a useful life of five years.

How much of the 2+1+1+1.5m = 5.5m total costs can be capitalised under IAS 38?

Solution

In the financial statements of Company C, only 1.5 million of expenditure could be capitalised, as it is only from 1 July 20X5 that all the development criteria are met. Even though the asset is likely to generate significant benefit, the previously expensed costs cannot be recognised as assets.

Question 8 Investment property (D.1)

Company D owns a large commercial plot which it has subdivided in order to use half of the plot for its corporate headquarters and to lease the second half to generate rental income. Company D provides its tenants with security, maintenance and cleaning services which add approximately 15% to the lease cost for the tenants. The directors propose to measure the investment property at fair value as they expect the land to increase in value.

Can Company D classify the unused portion of its plot as an investment property?

Solution

The company owns the entire plot and has divided it into two portions, so it appears likely that they can legally lease out the unused portion. Although the company provides its tenants with ancillary services these do not make up a significant component of the relationship. It will thus be appropriate for Company D to class its HQ as PPE, and the separate rented portion of the plot as investment property. If they elect to measure the asset at fair value, they will not charge depreciation on it, but will need to carry out an annual impairment review and recognise any change in profit and loss, or equity.

Question 9 Investment property (D.1)

Company D has been very successful and the directors have decided to move their HQ to a new larger plot more centrally located. They intend to retain the existing plot and convert the owner-occupied section into offices for rental. This section of the plot will be prepared in order for it to be classified as investment property. The fair value of the HQ section of the plot is 1.5 million, while its carrying value as PPE is 1.35 million.

What changes will be recognised in Company D's financial statements in respect of this transfer?

Solution

The fair value is greater than the carrying value and so a positive revaluation needs to be recognised. The amount will be recognised in other comprehensive income.

The entries will be:

Dr: Investment property	1.35m
Cr: PPE	1.35m
Dr: Investment property	0.15m
Cr: Revaluation reserve	0.15m

Remember that there will be no year-end depreciation charge since the investment property will be carried at fair value. Subsequent changes in fair value will need to be recognised at each reporting date.

Question 10 Calculation of impairment (D.1)

A piece of machinery was originally acquired for 100,000. It was expected to have a useful life of ten years and no residual value. It is depreciated on a straight-line basis.

At the start of year six, there was a downturn in demand due to a competitor product entering the market, and this has led to an impairment of the machinery. The impairment

has been calculated as being 20,000, although it is expected that the asset will continue to be productive at this level for its remaining five-year life.

What are the correct journal entries for the charges to the profit and loss statement for the impairment and depreciation?

Solution

At the end of year five, the asset had a carrying amount of:

100,000 × 5/10 years =	50,000
Carrying value	50,000
Impairment	20,000
New carrying value	30,000
New annual depreciation charge 30,000/5 =	6,000

The impairment of 20,000 should be recognised immediately in the statement of financial performance.

Dr:	Statement of Profit or Loss impairment	20,000
Cr:	Machinery non-current asset	20,000

Depreciation is also recorded as follows:

Dr:	Statement of Profit or Loss depreciation	6,000
Cr:	Machinery accumulated depreciation	6,000

Question 11 Identifying Financial Instruments (D.2)

1) A supermarket company anticipates rising prices for wheat and so enters into a forward contract for the provision of wheat based on its estimate of demand over the next six months.

Is this forward contract a financial instrument?

2) Which of the following meets the definition of a financial instrument?

(a) Accounts payable
(b) Cash
(c) L oan guarantees
(d) Shares
(e) Property
(f) Work in progress

Solution

1) The contract does not meet the definition of a financial instrument because it does not give rise to a financial liability on the one side and a financial asset on the other: settlement of the contract will involve the supermarket receiving inventory and not cash.

If the forward contract was purchased by an investment bank or hedge fund for the purpose of trading (and not to collect the wheat), it could meet the definition of a financial instrument. As you will see below, a lot depends on the purpose for which a financial instrument is held.

2) Accounts payable, cash, loan guarantees and shares are Examples of financial instruments. Physical assets such as property and inventory are not financial instruments because while they may generate cash inflows, they do not represent a right to receive cash or another financial asset.

Question 12 Cash flow hedge accounting (D.2)

On 1 December 20X4 a Rwandan company forecasts a significant sale in Tanzania which it expects to complete in 6 months. A hedging arrangement would be beneficial to reduce uncertainty about the value the company will receive in FRW when the contract is completed. The company therefore enters into a foreign currency forward contract with its bank to sell the 11 million TSHS it expects to receive for 8 million FRW on 31 May 20X5. This will allow the company to receive 8 million FRW irrespective of movements in the exchange rate. The following additional information is available:

- The functional currency of the company is FRW;
- The sale of 11 million. TSHS is expected in 6 months;
- Start date: 1 December 20X4, end date: 31 May 20X5;

On 31 December 20X5, due to changes in the exchange rate between FRW and TSHS, the fair value of the forward contract is a gain of 150,000 FRW; the fair value of the anticipated sale is a corresponding loss of 150,000 FRW. On 31 May 20X5 the exchange spot rate is 1.5 TSHS/FRW

What entries are needed to record this arrangement?

Solution

The entries that need to be made for this arrangement will need to reflect the year end revaluation, as well as the actual impact of the hedge at the point of completion in May 20X5. Effectiveness is not considered for the purposes of this Example.

At the year-end on 31 December 20X4, the forward contract is revalued as follows:

Dr: Derivative assets	150,000 FRW
Cr: OCI – Cash flow hedge reserve	(150,000) FRW

Since there was no ineffectiveness, there is nothing to recognise in profit or loss.

At the time of the sale on 31 May 20X5, it is necessary to calculate the fair value of the derivative first and recognise its fair value gain or loss.

Calculation:

To sell 11 million TSHS at the spot rate of 1.5 TSHS/FRW, the entity would receive 11m TSHS / 1.5 = 7,333,333 FRW.

To sell 11 million. TSHS at the contracted forward rate, the entity would receive 8 million. FR (which is more beneficial than above).

Total gain: 8,000,000 – 7,333,333 = 666,667 FRW.

Less already recognized in 20X4: 666,667 – 150,000 = 516,667 FRW.

The transaction should be recorded in three separate entries as follows:

Revaluation of hedging instrument to its fair value: The full gain is recognised as a cash flow hedge reserve in other comprehensive income. The entry is:

Dr: Derivative assets	516,667 FRW
Cr: OCI – Cash flow hedge reserve	(516,667) FRW

Settlement of forward contract with the bank:

Dr: Bank account	10,000,000 FRW
Cr: Bank accounts	(9,483,333) FRW
Cr: Derivative assets	(516,667) FRW

Transfer of cash flow hedge reserve to profit or loss, *because the hedged item (sale) affected profit or loss. The entry is*

Dr: OCI-Cash flow hedge reserve	666,667 FRW
Cr: P/L-Revenues from sales	(666,667) FRW And in addition, we need to recognise the regular sale transaction at the spot rate:
Dr: Trade receivables:	9,483,333 FRW
Cr: P/L – Revenues from sales	(9,483,333) FRW

Question 13 Amortisation of financial assets (D.3)

Company B issues debentures with a total par value of 50,000 on Jan 1 20X4 redeemable in three years and an annual interest rate or coupon of 8%, to be paid at the end of each year. The company pays an upfront fee of 2,000 to issue the debentures and the net proceeds are therefore 48,000.

The effective interest rate for the debentures is 9.59%.

At initial recognition the debentures are recognised at fair value less transaction costs.

What are the correct ledger entries?

Solution

In order to create the correct ledger entries to account for the debentures, we will need to establish the total amount to be paid in interest, which is determined by the coupon, or stated interest rate. We will then need to apply the effective interest rate to the debentures, in order to amortise the total cost of the debentures across their term.

Debentures valued at 50,000 @ 8% interest will require annual payments of 4,000. Over the term, the total interest paid will therefore be 4,000 x 3 years = 12,000.

In addition to the interest charge, the company has paid a fee of 2,000, which also needs to be amortised across the three years.

We can calculate the total cost of the debentures by adding the cash inflows and outflows as follows:

Receive Cash	48,000
Pay Interest	(12,000)
Principal Repayment	(50,000)
Financing Cost	(14,000)

We will therefore recognise the debentures with the following journal entry:

Dr: Bank	48,000
Cr: Debentures	48,000

Each year the company will pay 4,000 which will be recognised with the following journal entry:

Cr: Debentures	4,000
Dr: Interest Expense	4,000

Interest paid needs to be credited to the debentures to ensure that the balance matches the amount remaining to be amortised.

The balance carried forward in the table below shows how the amounts to be recognised in the statement of profit and loss and the statement of financial position are calculated. The Carried Forward balance is the value of the debentures at the reporting date. The coupon amount is recognised on the statement of financial position as a payable. The interest paid amount is shown each year in the statement of profit and loss as an expense.

Date	B/Fwd	Interest Paid @ 9.6%	Coupon @ 8%	C/Fwd
1 Jan 20x5	-	-	-	48,000
31 Dec 20x5	48,000	4,603	4,000	48,603
31 Dec 20x6	48,603	4,661	4,000	49,264
31 dec 20x7	49,264	4,735	54,000	0
Total		14,000	62,000	

Question 14 Expected credit losses (D.3)

Company A has a two-year loan receivable from a customer with a gross carrying amount of 2 million and interest rate of 1% per annum payable in two annual instalments.

At a reporting date, Company A has assessed that there has been no significant increase in credit risk from initial recognition. The loan is therefore classified in terms of credit risk under Stage 1, which means that the ECL will be calculated as the expected loss over the next 12 months.

The PD within 12 months has been calculated based on historical data at 2% and LGD is also calculated based on historical data is 5%.

What is the ECL discounted to?

Solution

The calculation of ECL would be:

EAD	PD	LGD	ECL	Discount rate	PV of ECLs	
1,010,000	2%	5%	1,010	1%	1,000	12-month ECL
				Total ECL	**1,000**	

IFRS 9 requires that ECLs are discounted to the reporting date applying the effective interest rate used at recognition. So, in the above Example, the calculated ECL of 1,010 is discounted to 1,000.

Question 15 Employee benefits (D.3)

Company A is a small tech start up that provides its 20 employees with a number of different benefits. All employees are entitled each year to:

- 25 days annual leave which accumulates up to a maximum of 40 days.
- 8 days non accumulating sick leave which must be supported by a doctor's note.
- A share of the company profits equal to 3% of net profits, divided equally between all eligible employees.

The following additional information is available:

- On average one day of annual and sick leave is worth 100
- The average accumulated leave is 10 days per employee
- The company's net profits at year end 20X4 were 500,000

Assuming that the profit share has not been paid at the reporting date, what is the value of the liability?

Solution

The value of the liability is calculated as follows:

Annual leave:	20 employees x 10 days x 100 currency units =	20,000
Profit share:	500 000 x 3% =	15,000
		35,000

Sick leave is not included in the liability because it does not accumulate.

Question 15 Pension schemes (D.3)

A company pension has assets of 70 and total obligations of 130 at its funding valuation (i.e. a funding deficit of 60), so has agreed to recovery payments of 20 per year for the next

3 years. The plan rules state that recovery payments cannot be avoided once committed and any surplus belongs to the members of the pension plan.

A year later, the pension deficit falls to 30 as the plan assets have increased in value (and also because the company has made its first recovery payment), but the company is still committed to making the remaining recovery payments of 40.

How should the pension disclosures in the notes be shown?

Solution

FV of pension assets	100
PV of pension obligations	(130)
Plan deficit	(30)
Asset ceiling adjustment	(10)
Pension liability on Statement of Financial Position	(40)

In this scenario, the actual deficit on the plan is 30, but the company has committed to pay 40 into the plan, so its reported liability reflects that larger obligation, rather than the shortfall in the plan itself.

Any deficit or surplus on the plan will be shown on the statement of financial position as a liability or asset respectively.

Question 16 Pension plan (D.3)

Company E has a defined benefit pension plan and the accountants have gathered the necessary information from actuaries and internal records to classify the relevant cash flows and balances under IAS 16. In respect of year end 20X4, the following information has been provided:

Current and past service cost	0.5m
Fair Value of the defined benefit asset	2m
Net interest on the defined benefit asset	0.2m
Present Value of defined benefit obligations	1.5m

Given the above information, what entries should be made on the statement of financial position and statement of financial performance?

Solution

Statement of Financial Position

Defined benefit asset 2 - 1.5 =	0.5m

Statement of Profit or Loss

Pension expenses	0.5m
Interest income on pension assets	0.2m

Question 17 Deferred taxation (D.4)

In 20X4, Entity A purchases a fixed asset for 1 000. With a useful life of 5 years, the annual depreciation charge under IAS 16 is 200. However, for tax purposes, Entity A can claim a 500 depreciation charge for the first 2 years. The entity generates an annual revenue of 800, taxable concurrently with IFRS recognition, at a 20% tax rate.

How should Entity A calculate the income tax payable to authorities?

Solution

The income tax payable to authorities, calculated by Entity A, is presented in the following table:

Financial statements					
	20X4	**20X5**	**20X6**	**20X7**	**20X8**
Revenue	800	800	800	800	800
Depreciation charge (under IAS 16)	(200)	(200)	(200)	(200)	(200)
Profit before tax (PBT)	600	600	600	600	600
Current income tax charge	(60)	(60)	(160)	(160)	(160)
Deferred income tax (charge)/credit	(60)	(60)	40	40	40
Total income tax charge	(120)	(120)	(120)	(120)	(120)
Net income	**480**	**480**	**480**	**480**	**480**
Effective tax rate (income tax/PBT)	*20%*	*20%*	*20%*	*20%*	*20%*
Effective tax rate without deferred tax	*10%*	*10%*	*27%*	*27%*	*27%*
Current income tax calculation payable to tax authorities					
	20X4	**20X5**	**20X6**	**20X7**	**20X8**
Revenue	800	800	800	800	800
Depreciation charge (tax law)	(500)	(500)	-	-	-
Taxable profit	300	300	800	800	800
Tax at 20%	60	60	160	160	160
Deferred income tax calculation at year-ends					
	20X4	**20X5**	**20X6**	**20X7**	**20X8**
Carrying amount of fixed asset	800	600	400	200	-

Tax base	500	-	-	-	-
Deferred tax liability	60	120	80	40	-
Cost of PP&E	***1 000***				

You can see from the table how the deferred tax liability is written down to equalise the impact of the accelerated depreciation allowed in the first two years, over the useful life of the asset. The tax base is calculated by taking the cost of the asset and deducting the applicable capital allowance, so the base is 1 000 – 500 = 500 in 20X4, and 500 – 500 = 0 in 20X5. The deferred tax liability is calculated by applying the applicable tax rate to difference between the tax base and the carrying amount of the asset, i.e. in 20X4 (800 – 500) x 20% = 60. Question 18 Inventory (D.4)

On 1 June 20X6, a company purchased inventory and paid for it by issuing shares to the supplier with a fair value of 6.3 million. The fair value of the inventory on 1 June 20X6 was 6 million.

How will this transaction be dealt with in the financial statements?

Solution

IFRS 2 states that the fair value of the goods and services received should be used to value the share options unless the fair value of the goods cannot be measured reliably. Thus, equity would be increased (CR Equity) by 6m and inventory increased (DR Inventory) by 6 million.

Question 19 Share options (D.4)

A company grants 2,000 share options to each of its three directors on 1 January 20X6. The options will vest on 31 December 20X8 if the directors are still employed and if the company's share price reaches 14 per share. The fair value of each option on 1 January 20X6 is 10.

The share price at 31 December 20X6 is 8 and it is not anticipated that it will rise over the next two years. At 31 December 20X6, it is anticipated that only two directors will still be employed on 31 December 20X8.

How will the share options be treated in the financial statements for the year ended 31 December 20X6?

Solution

The market-based condition (i.e. the increase in the share price) can be ignored for the purpose of the calculation. However, the employment condition must be taken into account.

2,000 options x 2 directors x 10 x 1 year / 3 years = 13,333

Equity will be increased (CR Equity) by 13,333 and an expense (DR P&L Expense) shown in profit or loss for the year ended 31 December 20X6.

Question 20 Share appreciation (D.4)

Jay is a public limited company with a year end of 31 July 20X6. on 1 August 20X5, it granted 300 share appreciation rights to each of its 500 employees. The vesting date is 31 July 20X7. The fair value of each share appreciation right on 31 July 20X6 is 15.

At 31 July 20X6, management believe that 80% of the employees will still be employed on 31 July 20X7.

How will the transaction be recorded in the year ended 31 July 20X6?

Solution

The liability is measured using the fair value of the rights at the reporting date. The expense is recognised over the vesting period of two years.

300 rights x 500 employees x 80% x 15 x 1 year / 2 years = 900,000

A liability of 900,000 should be recognised in the statement of financial position (CR Liability). A corresponding expense of 900,000 should be recognised in the statement of profit or loss (DR P&L Expense).

Question 21 Lease (D.4)

Company A enters into a three-year lease of an apartment. The apartment is in a multi-tenant building that includes shared facilities (e.g. a swimming pool and garden). In addition to the monthly lease payments, the contract includes an additional fee of 2,000 per quarter for the upkeep of the communal areas, maintenance and security. This fee does not cover costs for non-routine and 'major' maintenance, which are billed to tenants separately.

At commencement, the timing and extent of the landlord's performance of common area maintenance is unknown (e.g. because it's difficult to predict how many repairs will be needed). However, the lessor has committed to keep the building and common areas well maintained. Company A determines that the common area maintenance is a separate non-lease component because it transfers a good or service to them other than the right to use the apartment. That is, Company A receives a service that it would otherwise have to pay for separately (e.g. if its plumbing required repairs).

How should Company A allocate the total contract consideration?

Solution

Company A allocates the total contract consideration to the lease component and the non-lease component. Company A accounts for the lease component under IFRS 16, whereas common area maintenance charges of 2,000 per quarter are expensed when they are incurred.

Question 22 Non-cancellable lease (D.4)

Company D enters into a non-cancellable lease contract with Company E under which Company E leases non-specialised equipment from Company D for five years. The economic life of the equipment is estimated to be 15 years and legal title will remain with Company D. The lease contract contains no purchase, renewal or early termination options. The fair value of the equipment is 100,000 and the present value of the lease

payments amounts to 50,000.

In assessing the classification of the lease, Company D notes that:

- The lease does not transfer ownership of the equipment to Company E
- Company E has no option to purchase the equipment
- The lease term is for one-third of the economic life of the equipment, which is less than the major part of the economic life
- The present value of the lease payments amounts to 50% of the fair value of the equipment, which is less than substantially all of the fair value
- The equipment is not specialised.

How should company D classify the lease?

Solution

Company D notes that there are no indicators that the lease is a finance lease and that, based on an overall evaluation of the arrangement, the lease does not transfer substantially all of the risks and rewards incidental to the ownership of the equipment to Company E. Therefore, Company D classifies the lease as an operating lease.

Question 23 Fair value (D.4)

Company B sells a building to Company C for cash of 4.5 million, which is the fair value of the building. Immediately before the transaction, the carrying amount of the building in the financial statements of Company B was 3.5 million. At the same time, Company B enters into a contract with Company C for the right to use the building for 20 years, with annual payments of 200,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Company B satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15. Accordingly, Companies B and C account for the transaction as a sale and leaseback.

How would this be recognised in the financial statements of Company B?

Solution

The annual interest rate implicit in the lease is 5%. The cumulative discount factor for 5% for 20 years is 12,462. The present value of the annual payments (20 payments of 200,000, discounted at 5%) amounts to 2,492,400.

Company B would recognise a right-of-use-asset arising from the leaseback of the building. This would be measured as the proportion of the previous carrying amount that relates to the right of use retained by Company B. On this basis, the right of use asset would be calculated as follows:

Carrying amount of the building / fair value of the building x present value of expected lease payments

3,500,000/ 4,500,000 x 2,492,400 = 1938,533

Similarly, this could be calculated as the proportion of the equivalent asset retained by Company B.

The total gain on the sale of the building is 1,000,000 (4,500,000 fair value – 3,500,000 carrying amount). However, Company B can only recognise 446,133 as this is the amount

of the gain that relates to the rights transferred to Company C. This is calculated as:

(Total gain/ fair value x (fair value – present value of annual payments)

(1,000,000/ 4,500,000 x (4,500,000 – 2,492,400) = 446,133.

Question 24 Performance bonus (D.5)

Company E enters into a contract with Company F to build an asset for 100,000 with a performance bonus of 50,000 that will be paid based on the timing of completion. The amount of the performance bonus decreases by 10% per week for every week beyond the agreed-upon completion date. The contract requirements are similar to contracts Company E has performed previously, and management believes that such experience is predictive for this contract. Company E concludes that the expected value method is most predictive in this case.

Company E estimates that there is a 60% probability that the contract will be completed by the agreed-upon completion date, a 30% probability that it will be completed one week late, and a 10% probability that it will be completed two weeks late.

How should Company E determine the transaction price?

Solution

The transaction price should include management's estimate of the amount of consideration to which the reporting entity will be entitled for the work performed.

Probability-weighted consideration	
150,000 (fixed fee plus full performance bonus) x 60%	90,000
145,000 (fixed fee plus 90% of performance bonus) x 30%	43,500
140,000 (fixed fee plus 80% of performance bonus) x 10%	14,000
Total probability-weighted consideration	**147,500**

The total transaction price is 147,500 based on the probability-weighted estimate. Contractor will update its estimate at each reporting date.

Question 26 Transfer of assets (D.5)

Company F enters into a contract with a customer to build and supply a new machine. Control over the completed machine will pass to the customer in two years (which is the point in time at which Company F's performance obligation will be satisfied).

The contract contains two payment options allowing the customer to pay:

- 5 million in two years (when it obtains control of the machine), or
- 4 million at inception of the contract.

The customer decides to take the option of paying 4 million at inception.

What journal entries should Company F make in its accounts to reflect this transaction?

Solution

Company A concludes that, because of the significant period between the date of payment by the customer and the transfer of the machine to the customer, together with the effect of prevailing market rates of interest, there is a financing component which is significant to the contract.

The interest rate implicit in the transaction is 11.8% (which is the interest rate necessary to make the two alternative payment options economically equivalent). However, because Company F is effectively borrowing from its customer, Company F is also required to consider its own incremental borrowing rate, which is determined to be 6%.

At inception of the contract, Company A processes the following journal entry to recognise a contract liability:

Dr: Cash	4m
Cr: Contract Liability	4m

During the two years from contract inception until the transfer of the asset, Company F must adjust the promised amount of consideration, and increase the contract liability by recognising interest on 4m at 6% per year for two years.

Interest in Year 1 will be 240,000 (4,000,000 x 6%) and interest in Year 2 will be 254 400 ([4,000,000 + 240,000] x 6%). The journal entry for the two years combined (240,000 + 254,000) will be:

Dr: Interest Expense	494,000
Cr: Contract Liability	494,000

At the date of transfer of the machine to the customer, Company F then processes the following journal entry to recognise payment at inception + interest earned:

Dr: Contract Liability	4,494,000
Cr: Revenue	4,494,000

Question 27 Contract modification (D.5)

Company G enters into an arrangement with a customer to sell 100 machines for 100,000 (1000 per good). The goods are distinct and are transferred to the customer over a six-month period. The parties modify the contract in the fourth month to sell an additional 20 goods for 950 each. The price of the additional goods represents the standalone selling price on the modification date.

Should Company G account for the modification as a separate contract?

Solution

The modification to sell an additional 20 goods at 95 each should be accounted for as a separate contract because the additional goods are distinct and the price reflects their standalone selling price. The existing contract would not be affected by the modification.

Question 28 Recognition of specific transactions (D.5)

Company H negotiates with major airlines to obtain access to airline tickets at reduced rates and sells the tickets to end consumers through its website. Company H contracts

with airlines to buy a specific number of tickets at agreed-upon rates and must pay for those tickets regardless of whether it is able to resell them. End consumers visiting Company H's website search Company H's available tickets. Company H has discretion in establishing the prices for the tickets it sells to the end consumers.

Company H is responsible for delivering the ticket to the end consumer. Company H will also assist the end consumer in resolving complaints with the service provided by the airlines. The airline is responsible for fulfilling all other obligations associated with the ticket, including the air travel and related services (that is, the flight), and remedies for service dissatisfaction.

Is Company H the principal or an agent for the sale of an airline ticket to an end consumer?

Solution

Company H is the principal for the sale of the ticket to the end consumer and should recognise revenue for the price paid by the end consumer; that is, it should recognise revenue on a gross basis.

The specified good or service is a right to fly on the selected flight (represented by a ticket) along with the other rights provided by the airline for the holder of that ticket. Company H obtains control of the right to the airline's services (which it could resell or use itself) and transfers that right (represented by the ticket) to the end consumer. This conclusion is supported by the indicators of control:

- Although the airline is responsible for providing the air travel services, Company H is primarily responsible for fulfilling the promise to transfer a right to future services (the ticket) to the end consumer.
- Company H has inventory risk as a result of purchasing the ticket from the airline in advance and will be subject to the risks and rewards of ownership, including loss if it is unable to sell the ticket.
- Company H has discretion in establishing the selling price of the ticket.

Company H should recognize revenue equal to the price paid by the end consumer for the ticket when it transfers control of the ticket to the end consumer. It will recognise the cost of the ticket (the purchase price from the airline) as cost of sales.

Question 29 Licensing (D.5)

Company M enters into a contract with its customer for on-site data analytics software and cloud data storage. The on-site software utilises the customer's data stored on the cloud to provide data analysis. The software can also utilise data stored on the customer's premises or data stored by other vendors.

Is the software license distinct from the cloud storage?

Solution

Company M would likely conclude that the on-site software license is distinct from the cloud data storage service. The cloud data storage could be provided by other vendors and is capable of being distinct. The software license and cloud data storage service are not highly interrelated or interdependent because a customer could gain substantially all of the benefits of the software when data is stored on the customer's premises or with another vendor. Alternatively, if Company M's on-site software and cloud data storage

function together in such a manner that the customer gains significant functionality that would not be available without the cloud data storage service, Company M might conclude that the license is not distinct from the storage service.

Question 30 Repurchase agreement (D.5)

Company M is a car manufacturer that contracts with an independent reseller to sell 40 units of a particular car model at a price of 20,000 per unit. At the reseller's request, Company M agrees to repurchase any units six months after the date of the original sale. The agreement stipulates the vehicles will be repurchased at a value of 19 000 per unit. At the time of repurchase, the market value in six months is expected to be 16,000 per unit.

How should this transaction be classified using IFRS 15?

Solution

This particular repurchase agreement is a put option since the reseller has the right to require the Company M to repurchase the units. At a repurchase price of 19,000 per unit, the price is lower than the original selling price of 20,000 and therefore an assessment is required as to whether the customer has a significant economic incentive to exercise this right.

In this particular Example, at the end of the six-month period, the market value of such vehicles is expected to be 16,000. An argument may be made that the customer has significant economic incentive to exercise this right, since the amount to be received from Company M exceeds the expected market value. In this case, this transaction is not a "sale" that generates revenue within the scope of IFRS 15, but rather a lease transaction accounted for in accordance with IFRS 16 *Leases*.

Question 31 Fair value (D.6)

Company J has an asset that is sold in two different markets with similar volume of activities but with different prices. Company J enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. There is no principal market for the asset.

	Market A	Market B
Price	**27**	**25**
Transport Costs	**(3)**	**(2)**
Transaction Costs	**(3)**	**(1)**
	21	**22**

In market A, the price that would be received is 27; transaction costs in that market are 3; and the costs to transport the asset to that market are 3 (that is, the net amount that would be received in market A is 21). In market B, the price that would be received is 25; transaction costs in that market are 1; and the costs to transport the asset to that market are 2 (that is, the net amount that would be received in market B is 22).

What is the fair value of the asset?

Solution

As a principal market for the asset does not exist, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (that is, the net amount that would be received in the respective markets).

The entity would maximise the net amount that would be received for the asset in market B, so the fair value of the asset is measured using the price in that market, less transport costs, resulting in a fair value measurement of 23.

Although transaction costs are considered when determining which market is the most advantageous, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

Question 32 Agriculture industry (D.7)

Cattle Company

Company A raises cattle, slaughters them at its abattoirs and sells the carcasses to the local meat market. Which of these activities are in the scope of IAS 41?

Solution

The cattle are biological assets while they are living. When they are slaughtered, biological transformation ceases and the carcasses meet the definition of agricultural produce. Hence, entity A should account for the live cattle in accordance with IAS 41 and the carcasses as inventory in accordance with IAS 2.

Question 33 Wine industry (D.7)

Wine Company

Company B grows vines, harvests the grapes and produces wine. Which of these activities are in the scope of IAS 41?

Solution

The grapevines are biological assets that continually generate crops of grapes. When the entity harvests the grapes, their biological transformation ceases and they become agricultural produce. The grapevines continue to be living plants and should be recognised as biological assets. Assets such as wine that are subject to a lengthy maturation period are not biological assets. These processes are analogous to the conversion of raw materials to a finished product rather than biological transformation. Therefore, the entity should account for the grapevines in accordance with IAS 41 and the harvested grapes and the production of wine, as inventory in accordance with IAS 2.

Question 34 Public sector (D.9)

An entity agrees to construct and operate a section of motorway on behalf of the national roads authority. The fair value of the infrastructure/service concession asset is 300 million. The service concession arrangement runs for 10 years and will commence at the start of Year 2. The infrastructure/ service concession asset is made available for use at the end of Year 1.

The entity (i.e. the operator) will generate revenue from tolls charged to users of the road. The estimated useful economic life of the infrastructure/service concession asset is 15 years. Assuming performance of the service concession arrangement is as estimated, what information will the operator's financial statements contain?

Solution

Year 1 Statement of financial position

Property, plant and equipment	300 million
Performance obligation	300 million

Year 2 Statement of financial position

Property, plant and equipment	280 million (300m – 1/15)
Performance obligation	270 million (300m – 1/10)

Year 2 Statement of financial performance

Revenue	30 million
Depreciation	20 million

Unit E

Answers

Question	Answer
1	D
2	B
3	A
4	B
5	C
6	A
7	D
8	A
9	B

Explanations

1	E.1
Company A is the parent of four companies. Under which one of the following circumstances would it not be required to apply IFRS 10 in preparing consolidated financial statements:	
A	Company A is publicly listed
B	Company A issues bonds on the London Stock Exchange
C	Company A is a subsidiary of Company Z, which is listed on the New York Stock exchange and applies US GAAP
D	Company A is an investment company

1	Feedback
A	Incorrect – Company A is an investment company (answer C is incorrect because Company Z does not apply IFRS 10)
B	Incorrect – Company A is an investment company (answer C is incorrect because Company Z does not apply IFRS 10)

C	Incorrect – Company A is an investment company (answer C is incorrect because Company Z does not apply IFRS 10)
D	Correct – Company A is an investment company

2	**E.1**
Company L has acquired asset P in a transaction. Which one of the following indicates that that P represent a business:	
A	P's outputs are not sold on the open market
B	P provided investment services within its previous group
C	L paid 30% of its retained earnings to purchase P
D	L has acquired 60% ownership over P

2	**Feedback**
A	Incorrect – Selling on the open market may indicate that P is a business, but the opposite does not apply.
B	Correct – P provided a specific service comprising the three elements which indicate a business
C	Incorrect – The consideration paid is irrelevant to whether P is a business
D	Incorrect – The degree of ownership is irrelevant to whether P is a business

3	**E.1**
Company D acquires 75% of the shares of Company S on 31 December 20X5, for 100. The net assets of S recognised at the reporting date were valued at 120. The NCIs are measured proportionately to the fair value of the net assets. What is the value of goodwill reported in D's Statement of Financial Position	
A	10
B	190
C	50
D	5

3	**Feedback**
A	Correct – Goodwill is 100+ (120 x 25%) – 120 = 10

B	Incorrect – Goodwill is 100 + (120 x 25%) – 120 = 10
C	Incorrect – Goodwill is 100 + (120 x 25%) – 120 = 10
D	Incorrect – Goodwill is 100 + (120 x 25%) – 120 = 10

4	**E.1**
Parent Company Y's statement of financial position includes a loan principal receivable from subsidiary Company K of 150 balance at the year-end, which it repays at 30 per year. Which of the following represents the correct accounting entry to adjust for this loan on consolidation:	
A	Dr: Company K's current liabilities 150, Cr: Company Y's current assets 150
B	Dr: Company K's non-current liabilities 150, Cr: Company Y's non-current assets 150
C	Dr: Company K's retained earnings 150, Cr: Company Y's equity 150
D	Dr: Company Y's retained earnings, Cr: Company K's equity

4	**Feedback**
A	Incorrect – Dr: Company K's non-current liabilities 150, Cr: Company Y's non-current assets 150
B	Correct
C	Incorrect – Dr: Company K's non-current liabilities 150, Cr: Company Y's non-current assets 150
D	Incorrect – Dr: Company K's non-current liabilities 150, Cr: Company Y's non-current assets 150

5	**E.1**
Parent Company V holds 65% of the shares of subsidiary Company B. At year end, operating profit of Company B is 300, including revenue of 60 generated from sales to V, on which a profit of 20 was made and remained unrealised at the year-end. What is the value of the profit attributable to the NCI:	
A	135
B	99
C	108
D	126

5	Feedback
A	Incorrect – NCI is (300 – 20) x 45% = 126
B	Incorrect – NCI is (300 – 20) x 45% = 126
C	Correct – NCI is (300 – 20) x 45% = 126
D	Incorrect – NCI is (300 – 20) x 45% = 126

6	E.1
Company Q's profit and loss shows taxes paid at 31 March 20X5 of 70. The tax payable balance at 31 March 20X4 was 60 and the amount shown in payables at 31 March 20X5 is 45. What is the correct tax paid figure to use on the Statement of Cash Flows:	
A	85
B	35
C	55
D	115

6	Feedback
A	Correct – Cash taxes are 70+ (60 – 45) = 85
B	Incorrect – Cash taxes are 70+ (60 – 45) = 85
C	Incorrect – Cash taxes are 70+ (60 – 45) = 85
D	Incorrect – Cash taxes are 70+ (60 – 45) = 85

7	E.2
Which one of the following correctly describes the difference between an associate and a joint arrangement	
A	Joint venturers do not have significant control
B	Associates make decisions on a majority vote basis
C	Associates require a separate vehicle, whereas joint ventures do not
D	Joint ventures are defined by unanimous control, whereas associates are not

7	Feedback
A	Incorrect – Joint ventures are defined by unanimous control, whereas associates are not
B	Incorrect – Joint ventures are defined by unanimous control, whereas associates are not
C	Incorrect – Joint ventures are defined by unanimous control, whereas associates are not
D	Correct

8	E.2
Parent G acquires fixed assets from Associate X, in which it holds a 25% shareholding. The fixed assets are carried in X's books at 420, and G pays 380 consideration to acquire them, thereby indicating a reduction in the net realisable value of the assets. Which one of the following shows the correct accounting entry to adjust for the impairment identified in G's financial statements:	
A	Dr: Impairment 10, Cr: Investment in associate 10
B	Dr: Impairment 40, Cr: Investment in associate 40
C	Dr: Impairment 10, Cr: Fixed assets 10
D	Dr: Impairment 40, Cr: Fixed assets 40

8	Feedback
A	Correct – 420 – 380 = 40 x 25% = 10
B	Incorrect – 420 – 380 = 40 x 25% = 10 Dr: Impairment 10, Cr: Investment in associate 10
C	Incorrect – 420 – 380 = 40 x 25% = 10 Dr: Impairment 10, Cr: Investment in associate 10
D	Incorrect – 420 – 380 = 40 x 25% = 10 Dr: Impairment 10, Cr: Investment in associate 10

9	E.4
Which one of the following correctly describes the recognition and presentation criteria applied under the modified pooling of interest method:	
A	Comparative figures are required for all financial statements
B	Acquisition costs are expensed on recognition

C	NCI is measured at their share of the fair value of the investee's net assets
D	Intangible assets are recognised if they meet the requirements of IAS 38

9	**Feedback**
A	Incorrect – Comparators are optional. Acquisition costs are expensed on recognition
B	Correct
C	Incorrect – NCI is measured at carrying amount but adjusted for the proportionate share of adjustments made to harmonise accounting policies
D	Incorrect – Intangible assets are recognised only to the extent that they were already recognised in the combining entities prior to the amalgamation

Unit F

Case study 1

Quiz 1 - Solution

You should have noted that the information sources varied in their quality and coverage, and relying on one alone would not have been very productive. Media can be trustworthy, and industry specific publications are likely to be quite credible and non-sensational. Mainstream media often carries material written by public relations and press functions of companies, often without making this clear, so they should be treated with caution. In terms of the comparative ratios, they were reassuring but not very significant in importance, because the results were consistent with CIMERWA. Had they been very different, additional work would have been necessary.

The principal that should be applied when interpreting financial and non-financial information is "professional scepticism", which you learned about in Unit 1 on ethics.

Case study 2

Quiz 2 - Solution

There are valid justifications for both approaches, and it depends on how users are defined and the purpose of the financial information. One important factor to consider is the need to ensure that the outturn statement is at the same level of detail as the budget. In the case of Rwanda this would explain the absence of rounding, as the cash budget amounts reported on the relevant statement are also expressed in the Trillions without rounding. And in the UK, the budgets like the statements are rounded to the nearest Million, indicating that the decision is normally determined by budget needs rather than reporting needs. It could also be reasonably argued that the use of rounding is less appropriate to the public sector, due to the need for public accountability for all the money spent.

Unit G

Answers

Question	Answer
1	D
2	D
3	B

Explanations

1	G.1
The main difference between IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures* is that (choose one):	
A	S1 focuses on general sustainability risks, while S2 also considers opportunities
B	S1 provides a baseline and companies are expected to transition to reporting S2 related risks in subsequent periods
C	S1 refers to reporting against targets adopted by the company, whereas the S2 targets are agreed internationally
D	S1 covers risks to the sustainability of the business in general, while S2 covers risks arising from climate change

1	Feedback
A	Incorrect – S1 covers risks to the sustainability of the business in general, while S2 covers risks arising from climate change
B	Incorrect – S1 covers risks to the sustainability of the business in general, while S2 covers risks arising from climate change
C	Incorrect – S1 covers risks to the sustainability of the business in general, while S2 covers risks arising from climate change
D	Correct

2	G.1
Climate related scenario analysis is described in IFRS S2 as (choose one):	
A	A standardised method for analysing risk that can be tailored to specific industries
B	A specific set of inputs and assumptions that companies in different industries should apply
C	An analytical tool that should be used by companies registered on a US stock exchange
D	A generalised approach that should be followed, using inputs and assumptions that meet the company's circumstances

2	Feedback
A	Incorrect – A generalised approach that should be followed, using inputs and assumptions that meet the company's circumstances
B	Incorrect – A generalised approach that should be followed, using inputs and assumptions that meet the company's circumstances
C	Incorrect – A generalised approach that should be followed, using inputs and assumptions that meet the company's circumstances
D	Correct

3	G.1
Understanding Anti Money Laundering procedures is important for accountants because (choose one):	
A	They may be consulted by banks for advice on identifying money laundering
B	They are often the persons best placed to identify a money laundering transaction
C	IFAC requires all member accountants to be up to date with international money laundering rules
D	They may work for a company which is subject to anti money laundering rules

3	Feedback
A	Incorrect – They are often the persons best placed to identify a money laundering transaction
B	Correct
C	Incorrect – They are often the persons best placed to identify a money laundering transaction
D	Incorrect – They are often the persons best placed to identify a money laundering transaction

Unit H

Answers

Question	Answer
1	B
2	C
3	A
4	C

Explanation

1	H.1
Which one of the following is not identified as a benefit of using digital technology in financial reporting:	
A	More granular financial information improves potential investors' understanding of the company
B	Potential investors are able to access real time information about a company
C	Companies can more easily assess their comparative performance against other listed companies
D	Companies can use digital information to fulfil different types of disclosure requirements

1	Feedback
A	Incorrect – Potential investors are not given access to real time internal company information through digital technology
B	Correct
C	Incorrect – Reporting is directed to users as investors rather than as competitors.
D	Incorrect – The purpose is not to make it easier for companies to comply with requirements.

2	H.1
The application of tags to digital reports requires (choose one):	

A	Specialised knowledge of the XBRL structured data format
B	The use of a third-party tagging consultant
C	The application of the appropriate IFRS taxonomy to the report contents
D	The integration of the appropriate IFRS taxonomy into the accounting process

2	**Feedback**
A	Incorrect – The application of the appropriate IFRS taxonomy to the report contents
B	Incorrect – The application of the appropriate IFRS taxonomy to the report contents
C	Correct
D	Incorrect – The application of the appropriate IFRS taxonomy to the report contents is required. Integrating the taxonomy may precede application to reports.

3	**H.1**
Companies that use cloud-based accounting should **ensure** that the service provider (choose one):	
A	Has suitable data access restrictions
B	Is located in the same country
C	Applies IFRS in its accounting software
D	Recognises local requirements for financial reporting

3	**Feedback**
A	Correct
B	Incorrect – This may be advantageous but it is not as important as the service provider having suitable data access restrictions
C	Incorrect – This may be advantageous but it is not as important as the service provider having suitable data access restrictions
D	Incorrect – This may be advantageous but it is not as important as the service provider having suitable data access restrictions

4	H.1
AI may present a threat to accountants because (choose one):	
A	It can assign tags to financial captions thus eliminating the need for accountants to prepare financial statements
B	It is able to predict future trends based on analysis of granular data
C	It can eliminate the need for many basic bookkeeping processes
D	Instant access to financial records eliminates the need for audit

4	Feedback
A	Incorrect – Tags assigned by AI still need to be checked
B	Incorrect – It may be able to process more data, but it is not more capable of forecasting the future
C	Correct – Many basic bookkeeping roles are likely to become redundant
D	Incorrect – AI does not eliminate the need for audit

ICPAR
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