CHAPTER 24
Presentation and Disclosure in Financial Reporting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the full disclosure principle and how it is implemented.
2. Discuss the disclosure requirements for related-party transactions, subsequent events, major business segments, and interim reporting.
3. Identify the major disclosures in the auditor's report and management's responsibilities for the financial statements.
4. Describe other reporting issues related to implementation of the full disclosure principle.

This chapter also includes numerous conceptual discussions that are integral to the topics presented here.

PREVIEW OF CHAPTER 24

As the following opening story indicates, investors and other interested parties are concerned about the quality of information for all aspects of financial reporting—the financial statements, the notes, the president's letter, and management commentary. In this chapter, we cover the full disclosure principle in more detail and examine disclosures that must accompany financial statements so that they are not misleading. The content and organization of this chapter are as follows.

PRESENTATION AND DISCLOSURE IN FINANCIAL REPORTING

Full Disclosure Principle
- Increase in reporting requirements
- Differential disclosure
- Notes to the financial statements

Disclosure Issues
- Disclosure of special transactions or events
- Events after the reporting period
- Reporting for diversified conglomerate companies
- Interim reports

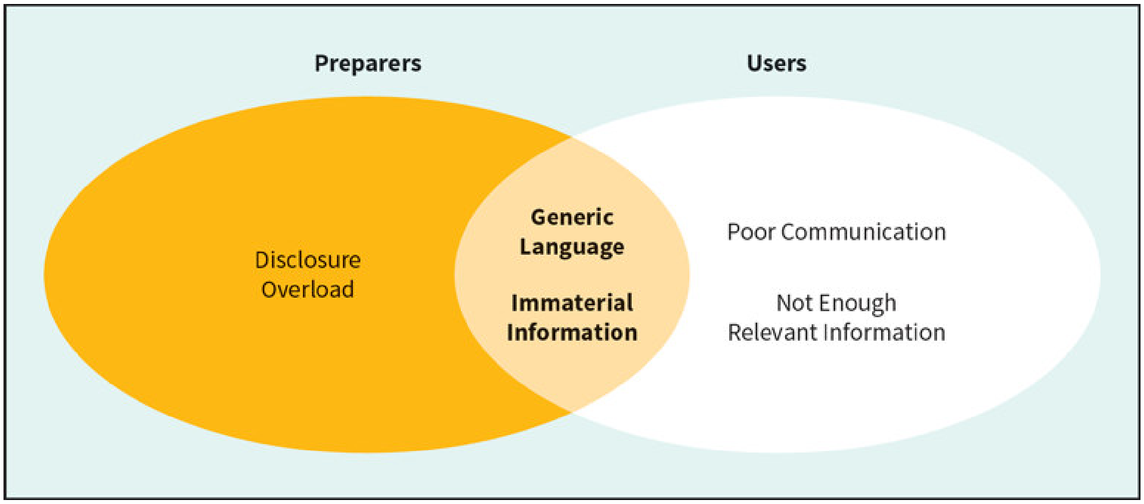
Auditor's and Management's Reports
- Auditor's report
- Management's reports

Current Reporting Issues
- Reporting on financial forecasts and projections
- Internet financial reporting
- Fraudulent financial reporting
- Criteria for making accounting and reporting choices

We Need Better, Not More

As you have learned in your study of this text, financial statements contain a wealth of useful information to help investors and creditors assess the amounts, timing, and uncertainty of future cash flows. In addition, the usefulness of accounting reports is enhanced when companies provide note disclosures to help statement readers understand how IFRS was applied to transactions. These additional disclosures help readers understand both the judgments that management made and how those judgments affected the amount reported in the financial statements. Some users, however, feel we need to go even further.

The IASB has heard these demands for improved financial reporting and disclosure and is responding. It organized a Discussion Forum and conducted a survey of preparers and users to get input on the effectiveness of reporting and disclosure in financial statements. The survey asked whether there is a disclosure problem and, if so, where in the annual report the problem arises. The survey focused on three potential areas: (1) not enough relevant information, (2) too much irrelevant information, and (3) poor communication of disclosures. The accompanying graphic summarizes the feedback.



As indicated, preparers viewed the disclosure problem as primarily one of information overload; that is, they are being required to provide too much data. Users, on the other hand, complained that some of the information they get is poorly communicated and not that relevant. The message that emerged from the Discussion Forum was similar. Specifically, increases in the volume of financial disclosures have resulted in a perceived reduction in their quality and usefulness. More importantly, there was broad consensus that collective action was required in order for improvements to be made.

As a result, the IASB has taken action in several areas:

1. The IASB implemented amendments to *IAS 1 Presentation of Financial Statements* to encourage companies to apply professional judgment in determining what information to disclose in their financial statements. Specifically, the amendments make clear that materiality applies to the whole of financial statements and that the inclusion of immaterial information can inhibit the usefulness of financial disclosures.
2. The IASB amended *IAS 7 Statement of Cash Flows* to require a disclosure of changes in liabilities arising from financing activities, including changes arising from cash flows and non-cash changes.
3. The IASB added a “better communication in financial reporting” theme to its agenda. This theme includes a number of projects, including adjusting the content of the primary financial statements, updating the previously issued practice statement on management commentary, and issuing a practice statement related to making materiality judgments. The practice statement includes a process for making such

judgments.[1] In addition, guidance on specific topics that often involve materiality judgments, including prior period reporting, errors, and interim reporting, is included.

Hans Hoogervorst, chair of the IASB, summarized the IASB's response as follows: "It is undoubtedly true that we and others can improve our [disclosure] requirements. However, material improvements will require behavioural change to ensure that financial statements are regarded as tools of communication rather than compliance. That means addressing the root causes of why preparers may err on the side of caution and 'kitchen-sink' their disclosures." The bottom line: We need better, not necessarily more, disclosure.

Review and Practice

Go to the **Review and Practice** section at the end of the chapter for a targeted summary review and practice problem with solution. Multiple-choice questions with annotated solutions, as well as additional exercises and practice problem with solutions, are also available online.

Full Disclosure Principle

LEARNING OBJECTIVE 1

Describe the full disclosure principle and how it is implemented.

The IASB Conceptual Framework notes that while some useful information is best provided in the financial statements, some is best provided by other means. For example, net income and cash flows are readily available in financial statements, but investors might do better to look at comparisons to other companies in the same industry, found in news articles or brokerage house reports.

IASB rules directly affect financial statements, notes to the financial statements, and supplementary information. These accounting standards provide guidance on recognition and measurement of amounts reported in the financial statements. However, due to the many judgments involved in applying IFRS, note disclosures provide important information about the application of IFRS. Supplementary information includes items such as disclosures about the risks and uncertainties, resources and obligations not recognized in the statement of financial position (such as mineral reserves), and information about geographical and industry segments. Other types of information found in the annual report, such as management commentary and the letters to shareholders, are not subject to IASB rules. **[1]** (See the Authoritative Literature References section near the end of the chapter.) **Illustration 24.1** indicates the various types of financial information.

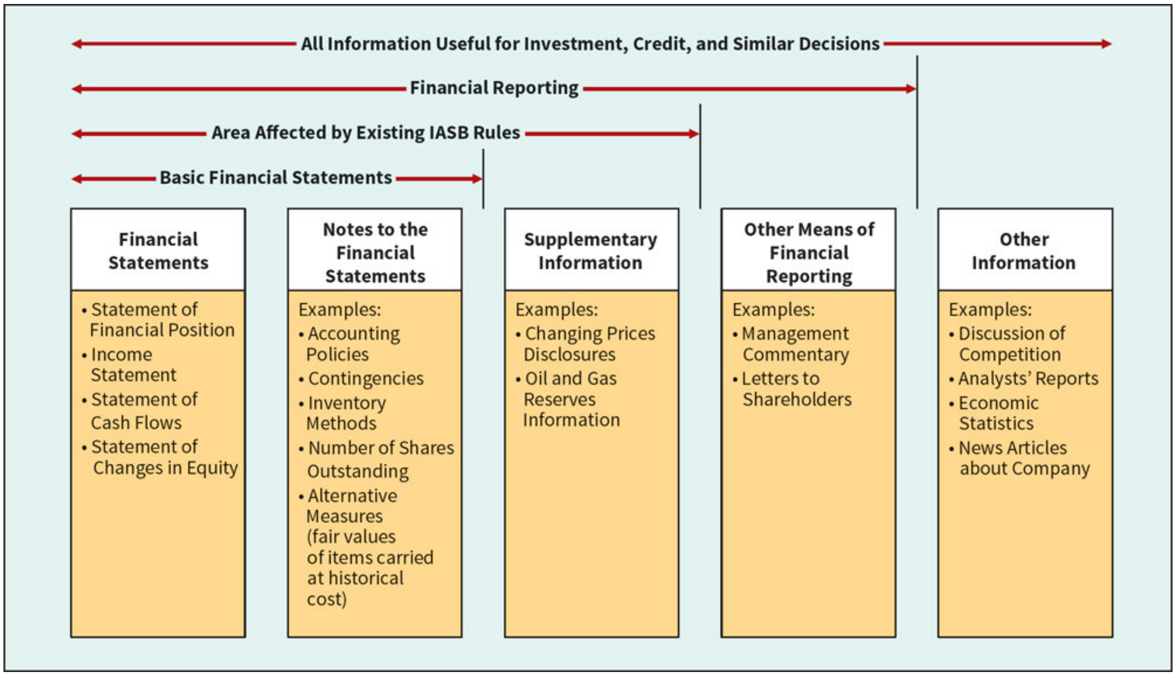


ILLUSTRATION 24.1 Types of Financial Information

As Chapter 2 indicated, the profession has adopted a **full disclosure principle**. The full disclosure principle calls for financial reporting of **any financial facts significant enough to influence the judgment of an informed reader**. In some situations, the benefits of disclosure may be apparent but the costs uncertain. In other instances, the costs may be certain but the benefits of disclosure not as apparent.

For example, the IASB requires companies to provide expanded disclosures about their contractual obligations. In light of the accounting frauds at companies such as **Steinhoff International** (ZAF), the benefits of these expanded disclosures seem fairly obvious to the investing public. While no one has documented the exact costs of disclosure in these situations, they would appear to be relatively small.

On the other hand, the cost of disclosure can be substantial in some cases and the benefits difficult to assess. For example, at one time the financial press reported that if segment reporting were adopted, a company such as **Fruehauf** (USA) would have had to increase its accounting staff 50 percent, from 300 to 450 individuals. In this case, the cost of disclosure can be measured, but the benefits are less well defined (see Underlying Concepts).

Underlying Concepts

Here is a good example of the trade-off between cost considerations and the benefits of full disclosure.

Some even argue that the reporting requirements are so detailed and substantial that users have a difficult time absorbing the information. These critics charge the profession with engaging in **information overload**.

Financial disasters at **Mahindra Satyam** (IND) and **Société Générale** (FRA) highlight the difficulty of implementing the full disclosure principle. They raise the issue of why investors were not aware of potential problems: Was the information these companies presented not comprehensible? Was it buried? Was it too technical? Was it properly presented and fully disclosed as of the financial statement date, but the situation later deteriorated? Or was it simply not presented? In the following sections, we describe the elements of high-quality disclosure that will enable companies to avoid these disclosure pitfalls.

Increase in Reporting Requirements

Disclosure requirements have increased substantially. One survey showed that the size of many companies' annual reports is growing in response to demands for increased transparency. For example, annual report page counts ranged from 164 pages for **Wm Morrison Supermarkets plc** (GBR) up to over 200 pages in **Puma's** (DEU) annual report. This result is not surprising; as illustrated throughout this text, the IASB has issued many pronouncements in the last 10 years that have substantial disclosure provisions.

The reasons for this increase in disclosure requirements are varied. Some of them are:

- **Complexity of the business environment.** The increasing complexity of business operations magnifies the difficulty of distilling economic events into summarized reports. Areas such as derivatives, leasing, business combinations, pensions, financing arrangements, revenue recognition, and deferred taxes are complex. As a result, companies extensively use **notes to the financial statements** to explain these transactions and their future effects.
- **Necessity for timely information.** Today, more than ever before, users are demanding information that is current and predictive. For example, users want more complete **interim data**.
- **Accounting as a control and monitoring device.** Regulators have increasingly sought public disclosure of such phenomena as management compensation, off-balance-sheet financing arrangements, and related-party transactions. Many of these newer disclosure requirements enlist accountants and auditors as the agents to assist in controlling and monitoring these concerns (see **Underlying Concepts**).[2]

Underlying Concepts

Surveys indicate that to meet users' changing needs, business reporting must (1) provide more forward-looking information; (2) focus more on the factors that create longer-term value, including non-financial measures; and (3) better align information reported externally with the information reported internally.

Differential Disclosure

A trend toward **differential disclosure** is also occurring. The IASB has developed IFRS for small- and medium-sized entities (SMEs). SMEs are entities that publish general-purpose financial statements for external users but do not issue shares or other securities in a public market. SMEs are estimated to account for over 95 percent of all companies around the world. Many believe a simplified set of standards makes sense for these companies because they do not have the resources to implement full IFRS.

Simplified IFRS for SMEs is designed to meet their needs and capabilities. Compared with full IFRS (and many national accounting standards), simplified IFRS for SMEs is less complex in a number of ways:

- Topics not relevant for SMEs are omitted. Examples are earnings per share, interim financial reporting, and segment reporting.
- Simplified IFRS for SMEs allows fewer accounting policy choices. For example, there is no option to revalue property, equipment, or intangibles.
- Many principles for recognizing and measuring assets, liabilities, revenue, and expenses are simplified. For example, goodwill is amortized (as a result, there is no annual impairment test) and all borrowing and R&D costs are expensed.
- Significantly fewer disclosures are required (roughly 300 versus 3,000).
- To further reduce standard overload, revisions to the IFRS for SMEs will be limited to once every three years.

Thus, the option of using simplified IFRS helps SMEs meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective. [2]

Notes to the Financial Statements

As you know from your study of this text, notes are an integral part of the financial statements of a business enterprise. However, readers of financial statements often overlook them because they are highly technical and often appear in small print. **Notes are the means of amplifying or explaining the items presented in the main body of the statements.** They can explain in qualitative terms information pertinent to specific financial statement items. In addition, they can provide supplementary data of a quantitative nature to expand the information in the financial statements. Notes also can explain restrictions imposed by financial arrangements or basic contractual agreements. Although notes may be technical and difficult to understand, they provide meaningful information for the user of the financial statements.

Accounting Policies

Accounting policies are the specific principles, bases, conventions, rules, and practices applied by a company in preparing and presenting financial statements. IFRS states that information about the accounting policies adopted by a reporting entity is essential for financial statement users in making economic decisions. It recommends that companies should present **as an integral part of the financial statements a statement identifying the accounting policies adopted and followed by the reporting entity**. Companies whose financial statements comply with IFRS must make an explicit and unreserved statement of such compliance. Companies should present the disclosure as the first note or in a separate Summary of Significant Accounting Policies section preceding the notes to the financial statements.

The Summary of Significant Accounting Policies answers such questions as: What method of depreciation is used on plant assets? What valuation method is employed on inventories? What amortization policy is followed in regard to intangible assets? How are marketing costs handled for financial reporting purposes? You can see a good example of note disclosure for

Marks and Spencer plc (GBR) (which accompanies the financial statements presented in Appendix A) at the company's website.

Analysts examine carefully the summary of accounting policies to determine whether a company is taking a conservative or an aggressive approach to accounting practices. For example, depreciating plant assets over an unusually long period of time is considered aggressive. Using weighted-average inventory valuation in a period of inflation is generally viewed as conservative.

In addition to disclosure of significant accounting policies, companies must:

1. Identify the judgments that management made in applying the accounting policies which have the most significant effect on the amounts recognized in the financial statements, and
2. Disclose management's assumptions about the future (and other major sources of estimation uncertainty at the end of the reporting period), that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect to those assets and liabilities, the notes should include details of (a) their nature and (b) their carrying amount as of the end of the reporting period.

Many times these disclosures are presented with the accounting policy note or provided in a specific policy note. The disclosures should identify the estimates that require management's most difficult, subjective, or complex judgments. **[3]** An example of this disclosure is presented in **Illustration 24.2** for **International Airlines Group** (GBR).

2. Significant accounting policies

Critical accounting judgements, estimates (in part) and assumptions

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. These judgements, estimates and associated assumptions are based on historical experience and various other factors believed to be reasonable under the circumstances. Actual results in the future may differ from judgements and estimates upon which financial information has been prepared. These underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised prospectively.

Revenue recognition

Passenger revenue is recognised when the transportation is provided. At the time of transportation, revenue is also recognised in respect of tickets that are not expected to be used (‘unused tickets’). Revenue associated with unused tickets is estimated based on the terms and conditions of the tickets and historical trends.

Revenue associated with the issuance of points under customer loyalty programmes is based on the relative stand-alone selling prices of the related performance obligations (brand, marketing and points), determined using estimation techniques. The transaction price of brand and marketing services is determined using specific brand valuation methodologies. The transaction price of the points is based on the value of the awards for which the points can be redeemed and is reduced to take account of the proportion of the award credits that are not expected to be redeemed by customers. The Group estimates the number of points not expected to be redeemed (using statistical modelling and historical trends) and the mix and fair value of the award credits. A one percentage point change in the assumption of points not expected to be redeemed will result in an adjustment to deferred revenue of €100 million, with an offsetting adjustment to revenue and operating profit recognised in the year.

The following estimate involves a higher degree of judgement or complexity, or is where assumptions are significant to the financial statements. However, this accounting estimate is not a major source of estimation uncertainty that has a significant risk of resulting in material adjustment to the carrying amounts of assets and liabilities within the next year.

Impairment of non-financial assets

The Group assesses whether there are any indicators of impairment for all non-financial assets at each reporting date. Goodwill and intangible assets with indefinite economic lives are tested for impairment annually and at other times when such indicators exist. The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates and assumptions as disclosed in note 14.

Other non-financial assets are tested for impairment when there are indicators that the carrying amounts may not be recoverable.

ILLUSTRATION 24.2 Accounting Estimate and Judgment Disclosure

Collectively, these disclosures help statement readers evaluate the quality of a company's accounting policies in providing information in the financial statements for assessing future cash flows. Companies that fail to adopt high-quality reporting policies may be heavily penalized by the market. For example, when **Isoft** (GBR) disclosed that it would restate prior-year results due to use of aggressive revenue recognition policies, its share price dropped over 39 percent in one day. Investors viewed Isoft's quality of earnings as low.

Common Notes

We have discussed many of the **notes to the financial statements** throughout this text and will discuss others more fully in this chapter. The more common are as follows.

Major Disclosures

Inventory. Companies should report the basis upon which inventory amounts are stated (lower-of-cost-or-net realizable value) and the method used in determining cost (FIFO, average-cost, etc.). Manufacturers should report, either in the statement of financial position or in a separate schedule in the notes, the inventory composition (finished goods, work in process, raw materials). Unusual or significant financing arrangements relating to inventories that may require disclosure include transactions with related parties, product financing arrangements, firm purchase commitments, and pledging of inventories as collateral. Chapter 9 illustrates these disclosures.

Property, Plant, and Equipment. Companies should state the basis of valuation for property, plant, and equipment (e.g., revaluation or historical cost). It is usually historical cost. Companies also should disclose pledges, liens, and other commitments related to these assets. In the presentation of depreciation, companies should disclose the following in the financial statements or in the notes: (1) depreciation expense for the period; (2) balances of major classes of depreciable assets, by nature and function, at the statement date; (3) accumulated depreciation, either by major classes of depreciable assets or in total, at the statement date; and (4) a general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets. Finally, companies should explain any major impairments. Chapter 11 illustrates these disclosures.

Creditor Claims. Investors normally find it extremely useful to understand the nature and cost of creditor claims. However, the liabilities section in the statement of financial position can provide the major types of liabilities only in the aggregate. Note schedules regarding such obligations provide additional information about how a company is financing its operations, the costs that it will bear in future periods, and the timing of future cash outflows. Financial statements must disclose for each of the five years following the date of the statements, the aggregate amount of maturities and sinking fund requirements for all long-term borrowings. Chapter 14 illustrates these disclosures.

Equityholders' Claims. Many companies present in the body of the statement of financial position information about equity securities: the number of shares authorized, issued, and outstanding and the par value for each type of security. They may also present such data in a note. Beyond that, a common equity note disclosure relates to contracts and senior securities outstanding that might affect the various claims of the residual equity holders. An example would be the existence of outstanding share options, outstanding convertible debt, redeemable preference shares, and convertible preference shares. In addition, it is necessary to disclose certain types of restrictions currently in force. Generally, these types of restrictions involve the amount of earnings available for dividend distribution. Examples of these types of disclosures are illustrated in Chapter 15 and Chapter 16.

Contingencies and Commitments. A company may have gain or loss contingencies that are not disclosed in the body of the financial statements. These contingencies include litigation, debt and other guarantees, possible tax assessments, renegotiation of government contracts, and sales of receivables with recourse. In addition, companies should disclose in the notes commitments that relate to dividend restrictions, purchase agreements (through-put and take-or-pay), hedge contracts, and employment contracts. Disclosures of such items are illustrated in Chapter 7, Chapter 9, and Chapter 13.

Fair Values. Companies that have assets or liabilities measured at fair value generally disclose both the cost and the fair value in the notes to the financial statements. Fair value measurements may be used for many financial assets and liabilities; investments; revaluations for property, plant, and equipment; impairments of long-lived assets; and some contingencies. Companies also provide disclosure of information that enables users to determine the extent of usage of fair value and the inputs used to implement fair value measurement. This fair value hierarchy identifies three broad levels related to the measurement of fair values (Levels 1, 2, and 3). The levels indicate the subjectivity of the measurement of fair value information. Chapter 17 discusses in detail fair value disclosures.

Deferred Taxes, Pensions, and Leases. The IASB also requires extensive disclosure in the areas of deferred taxes, pensions, and leases. Chapter 19, Chapter 20, and Chapter 21 discuss in detail each of these disclosures. Users of financial statements should carefully read notes to the financial statements for information about off-balance-sheet commitments, future financing needs, and the quality of a company's earnings.

Changes in Accounting Policies. The profession defines various types of accounting changes and establishes guides for reporting each type. Companies discuss, either in the summary of significant accounting policies or in the other notes, changes in accounting policies (as well as material changes in estimates and corrections of errors). See Chapter 22.

In earlier chapters, we discussed the disclosures listed above. The following sections of this chapter illustrate four additional disclosures of significance—special transactions or events, subsequent events, segment reporting, and interim reporting.

What Do the Numbers Mean?

Footnote Secrets

Often, note disclosures are needed to give a complete picture of a company's financial position. A good example is the required disclosure of collateral arrangements in repurchase agreements. Such arrangements gained front-page coverage when it was revealed that the now-defunct **Lehman Brothers** (USA)—and many other U.S. and European financial institutions—employed specialized repurchase agreements, referred to as Repo 105 (or Repo 108 in Europe), to "window-dress" their statements of financial positions. Here's how it works.

A repurchase agreement amounts to a short-term loan, exchanging collateral for cash upfront and then unwinding the trade as soon as overnight. Lehman's Repo 105 used a variety of holdings as the collateral. Lehman made the exchanges with major global financial institutions, such as **Barclays** (GBR), **UBS** (CHE), **Mitsubishi UFJ Financial Group** (JPN), and **KBC Bank** (BEL). What was special about the Repo 105/108 is that the value of the securities Lehman pledged in the transactions was worth 105 percent of the cash it received. That is, the firm was taking a haircut on the transactions. And when Lehman eventually repaid the cash it received from its counterparties, it did so with interest, making this a rather expensive technique. Under accounting guidance at that time, Lehman could book each transaction as a "sale" rather than a "financing," as most repos are regarded. That meant that for a few days, Lehman could exclude tens of billions of dollars in assets to appear more financially healthy than it really was.

Another recent example is the accounting for media content expenses compared to the true cost. For a company like **Netflix** (USA), its increased licensing fees are recognized in income on a delayed basis. In 2014 alone, Netflix paid $500 million more to add to its library than it recognized in expenses. These differences represented about 10 percent of expenses and would have reduced EPS from $4.32 to –$1.31. Netflix's accounting follows the rules, but you might not be able to compare it to the growing number of global media competitors that could be using different accounting policies for program costs.

How can you be better informed about note disclosures that may contain important information related to your investments, like Repo 105 and media content costs? The **Calcbench** (USA) website provides a good online resource for understanding the contents of note disclosures. The site highlights insights that can be gained by mining the information in financial statements, including footnotes. For example, some recent reports on the site have highlighted such issues as the substantial changes revealed by the new leasing standard (such as at **Starbucks** (USA), different discounts rates used by companies, and recent changes in product warranty accruals.

Sources: Gretchen Morgenson, "Annual Reports: More Pages, but Better?" *The New York Times* (March 17, 2002); M. de la Merced and J. Werdigier, "The Origins of Lehman's 'Repo 105'," *The New York Times* (March 12, 2010); New Constructs, "Three Ways Accounting Tricks Hidden in Footnotes Can Blow Up Your Portfolio," *Diligence Pays* (September 23, 2015); and "A Look at Product Warranty Accruals," Calcbench Blog (November 12, 2019).

Disclosure Issues

LEARNING OBJECTIVE 2

Discuss the disclosure requirements for related-party transactions, subsequent events, major business segments, and interim reporting.

Disclosure of Special Transactions or Events

Related-party transactions, errors, and fraud pose especially sensitive and difficult problems. The accountant/auditor who has responsibility for reporting on these types of transactions must take care to properly balance the rights of the reporting company and the needs of financial statement users.

Related-party transactions arise when a company engages in transactions in which one of the parties has the ability to significantly influence the policies of the other. They may also occur when a non-transacting party has the ability to influence the policies of the two transacting parties.[3] Competitive, free-market dealings may not exist in related-party transactions, and so an "arm's-length" basis cannot be assumed. Transactions such as borrowing or lending money at abnormally low or high interest rates, real estate sales at amounts that differ significantly from appraised value, exchanges of non-monetary assets, and transactions involving companies that have no economic substance (shell corporations) suggest that related parties may be involved.

In order to make adequate disclosure, companies should report the economic substance, rather than the legal form, of these transactions. IFRS requires the following minimum disclosures of material related-party transactions. **[5]**

1. The nature of the related-party relationship;
2. The amount of the transactions and the amount of outstanding balances, including commitments, the nature of consideration, and details of any guarantees given or received;
3. Provisions for doubtful debts related to the amount of outstanding balances; and
4. The expense recognized during the period with respect to bad or doubtful debts due from related parties.

Illustration 24.3, from the annual report of **Volkswagen AG** (DEU), shows disclosure of related-party transactions.

Volkswagen AG

Note 44. Related Parties

The following tables present the amount of supplies and services transacted, as well as receivable and liabilities, between consolidated companies of the Volkswagen Group and related parties.

	Supplies & Services Rendered		**Supplies & Services Received**	
(€ million)	**2018**	**2017**	**2018**	**2017**
Porsche SE and its majority interests	3	7	3	1
Supervisory Board members	4	2	2	2
Unconsolidated subsidiaries	1,137	1,029	1,649	1,300
Joint ventures and their majority interests	16,724	14,294	491	1,225
Associates and their majority interests	194	214	1,267	733
Pension plans	1	1	2	0
Other related parties	0	0	1	0
State of Lower Saxony, its majority interests and joint ventures	10	11	8	9

	Receivables From		**Liabilities To**	
(€ million)	**2018**	**2017**	**2018**	**2017**
Porsche SE and its majority interests	4	13	1	0
Supervisory Board members	0	0	205	254
Board of Management members	0	0	78	72
Unconsolidated subsidiaries	1,319	1,480	1,869	1,773
Joint ventures and their majority interests	11,989	9,889	2,671	2,168
Associates and their majority interests	112	76	487	572
Pension plans	1	1	—	—
Other related parties	—	—	100	63
State of Lower Saxony, its majority interests and joint ventures	1	2	2	1

ILLUSTRATION 24.3 **Disclosure of Related-Party Transactions**

Many companies are involved in related-party transactions. However, another type of special event, errors and fraud (sometimes referred to as irregularities), is the exception rather than the rule. Accounting **errors** are **unintentional** mistakes, whereas **fraud** (misappropriation of assets and fraudulent financial reporting) involves **intentional** distortions of financial statements.[4] As indicated earlier, companies should correct financial statements when they discover errors. Fraud should be given the same treatment. Its discovery gives rise to a different set of procedures and responsibilities for the accountant/auditor, however.

Disclosure plays an important role in these types of transactions because the events are many times more qualitative than quantitative and involve more subjective than objective evaluation. Users of the financial statements need some indication of the existence and nature of these transactions, through disclosures, modifications in the auditor's report, or reports of changes in auditors.

Events After the Reporting Period (Subsequent Events)

Notes to the financial statements should explain any significant financial events that took place after the formal statement of financial position date, but before the statements are authorized for issuance (hereafter referred to as the authorization date). These events are referred to as **events after the reporting date** or **subsequent events**. **Illustration 24.4** shows a time diagram of the subsequent events period.

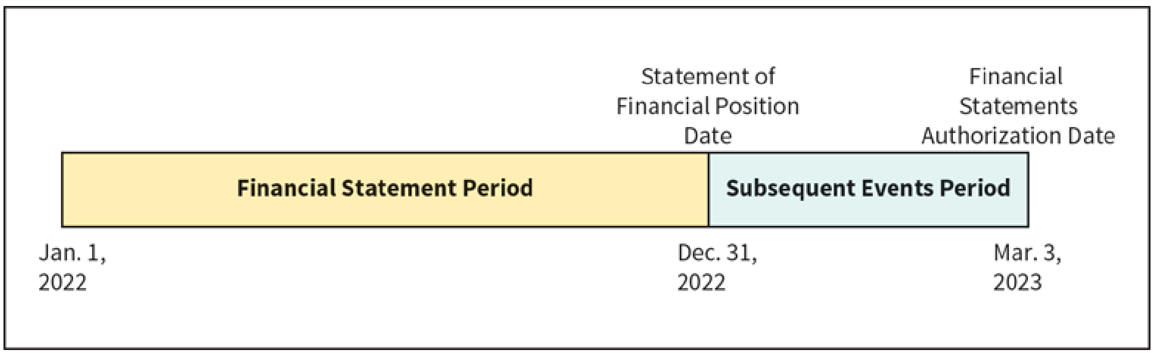


ILLUSTRATION 24.4 Time Periods for Subsequent Events

A period of several weeks or sometimes months may elapse after the end of the fiscal year but before the management or the board of directors authorizes issuance of the financial statements.[5] Various activities involved in closing the books for the period and issuing the statements take time: taking and costing the inventory, reconciling subsidiary ledgers with controlling accounts, preparing necessary adjusting entries, ensuring that all transactions for the period have been entered, obtaining an audit of the financial statements by independent certified public accountants, and printing the annual report. During the period between the statement of financial position date and its authorization date, important transactions or other events may occur that materially affect the company's financial position or operating situation.

Many who read a statement of financial position believe the financial condition is constant, and they project it into the future. However, readers must be told if the company has experienced a significant change—e.g., sold one of its plants, acquired a subsidiary, suffered unusual losses, settled significant litigation, or experienced any other important event—in the post-statement of financial position period. Without an explanation in a note, the reader might be misled and draw inappropriate conclusions (see **Underlying Concepts**).

Underlying Concepts

The periodicity or time period assumption implies that economic activities of an enterprise can be divided into artificial time periods for purpose of analysis.

Two types of events or transactions occurring after the statement of financial position date may have a material effect on the financial statements or may need disclosure so that readers interpret these statements accurately:

1. Events that provide additional evidence about conditions **that existed** at the statement of financial position date, including the estimates inherent in the process of preparing financial statements. These are referred to as **adjusted subsequent events** and require adjustments to the financial statements. All information available prior to the authorization date of the financial statements helps investors and creditors evaluate previous estimates. To ignore these subsequent events is to neglect an opportunity to improve the accuracy of the financial statements. This first type of event encompasses information that an accountant would have recorded in the accounts had the information been known at the statement of financial position date.

   For example, if a loss on an account receivable results from a customer's bankruptcy subsequent to the statement of financial position date, the company adjusts the financial statements before their issuance. The bankruptcy stems from the customer's poor financial health existing at the statement of financial position date.

   The same criterion applies to settlements of litigation. The company must adjust the financial statements if the events that gave rise to the litigation, such as personal injury or patent infringement, took place prior to the statement of financial position date.

2. Events that provide evidence about conditions that **did not exist** at the statement of financial position date but which arise subsequent to that date. These events are referred as **non-adjusted subsequent events** and do not require adjustment of the financial statements. To illustrate, a loss resulting from a customer's fire or flood *after* the statement of financial position date does not reflect conditions existing at that date. Thus, adjustment of the financial statements is not necessary. A company should not recognize subsequent events that provide evidence about conditions that did not exist at the date of the statement of financial position but which arose after the statement of financial position date.

The following are examples of non-adjusted subsequent events:

- A major business combination after the reporting period or disposing of a major subsidiary.
- Announcing a plan to discontinue an operation or to commence the implementation of a major restructuring.
- Major purchases of assets, other disposals of assets, or expropriation of major assets by government.
- The destruction of a major production plant or inventories by a fire or natural disaster after the reporting period.

- Major ordinary share transactions and potential ordinary share transactions after the reporting period.
- Abnormally large changes after the reporting period in asset prices, foreign exchange rates, or taxes.
- Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees after the statement date. [7][6]

Some non-adjusted subsequent events may have to be disclosed to keep the financial statements from being misleading. For such events, a company discloses the nature of the event and an estimate of its financial effect (see **Underlying Concepts**).

Underlying Concepts

A company also should consider supplementing the historical financial statements with pro forma financial data. Occasionally, a non-adjusted subsequent event may be so significant that disclosure can best be made by means of pro forma financial data.

Illustration 24.5 presents an example of subsequent events disclosure, excerpted from the annual report of **A.P. Møller - Maersk** (DNK).

A.P. Møller - Maersk

Note 26. Subsequent Events

On 21 February 2019, the Board of Directors has decided to initiate the separation of the drilling activities through a demerger. The shares in Maersk Drilling Holding A/S (Maersk Drilling) and its subsidiaries as well as certain other assets and liabilities will be contributed to a new company with the legal name “The Drilling Company of 1972 A/S”. The Board of Directors intends to propose the demerger for approval by the shareholders of A.P. Møller - Mærsk A/S at the Annual General Meeting on 2 April 2019.

Subject to approval at the Annual General Meeting, the shares in Maersk Drilling will be distributed to A.P. Møller - Maersk shareholders with anticipated first day of trading on 4 April 2019. The A.P. Møller - Maersk Board of Directors intends to propose a single share class structure for Maersk Drilling with the new listed shares being distributed on a pro-rata basis based on the nominal value of the shares in A.P. Møller - Mærsk A/S. Shareholders will receive one share in Maersk Drilling per nominal A.P. Møller - Maersk DKK 500 share and two shares in Maersk Drilling per nominal A.P. Møller - Maersk DKK 1,000 share.

ILLUSTRATION 24.5 Disclosure of Subsequent Events

Many subsequent events or developments do not require adjustment of or disclosure in the financial statements. Typically, these are non-accounting events or conditions that management normally communicates by other means. These events include legislation, product changes, management changes, strikes, unionization, marketing agreements, and loss of important customers.

Reporting for Diversified (Conglomerate) Companies

In certain business climates, companies have a tendency to diversify their operations. Take the case of **Siemens AG** (DEU), whose products include energy technologies, consumer products, and financial services. When businesses are so diversified, investors and investment analysts want more information about the details behind conglomerate financial statements. Particularly, they want income statement, statement of financial position, and cash flow information on the **individual segments** that compose the total income figure.

Much information is hidden in the aggregated totals. With only the consolidated figures, the analyst cannot tell the extent to which the differing product lines **contribute to the company's profitability**, **risk**, **and growth potential**. For example, in **Illustration 24.6**, the office equipment segment looks like a risky venture. Segmented reporting would provide useful information about the two business segments and would be helpful in making an informed investment decision regarding the whole company.

Office Equipment and Auto Parts Company Income Statement Data (in millions)			
	Consolidated	Office Equipment	Auto Parts
Net sales	$78.8	$18.0	$60.8
Manufacturing costs			
Inventories, beginning	12.3	4.0	8.3
Materials and services	38.9	10.8	28.1
Wages	12.9	3.8	9.1
Inventories, ending	(13.3)	(3.9)	(9.4)
	50.8	14.7	36.1
Selling and administrative expenses	12.1	1.6	10.5
Total operating expenses	62.9	16.3	46.6
Income before taxes	15.9	1.7	14.2
Income taxes	(9.3)	(1.0)	(8.3)
Net income	$ 6.6	$ 0.7	$ 5.9

ILLUSTRATION 24.6 Segmented Income Statement

A classic situation that demonstrates the need for segmented data involved **Caterpillar, Inc.** (USA). Market regulators cited Caterpillar because it failed to tell investors that nearly a quarter of its income in one year came from a Brazilian unit and was non-recurring in nature. The company knew that different economic policies in the next year would probably greatly affect earnings of the Brazilian unit. But Caterpillar presented its financial results on a consolidated basis, not disclosing the Brazilian operations. Caterpillar's failure to include information about Brazil left investors with an incomplete picture of the company's financial results and denied investors the opportunity to see the company “through the eyes of management.”

Companies have always been somewhat hesitant to disclose segmented data for various reasons:

1. Without a thorough knowledge of the business and an understanding of such important factors as the competitive environment and capital investment requirements, the investor may find the segmented information meaningless or may even draw improper conclusions about the reported earnings of the segments.
2. Additional disclosure may be helpful to competitors, labor unions, suppliers, and certain government regulatory agencies, and thus harm the reporting company.
3. Additional disclosure may discourage management from taking intelligent business risks because segments reporting losses or unsatisfactory earnings may cause shareholder dissatisfaction with management.
4. The wide variation among companies in the choice of segments, cost allocation, and other accounting problems limits the usefulness of segmented information.
5. The investor is investing in the company as a whole and not in the particular segments, and it should not matter how any single segment is performing if the overall performance is satisfactory.
6. Certain technical problems, such as classification of segments and allocation of segment revenues and costs (especially “common costs”), are formidable.

On the other hand, the advocates of segmented disclosures offer these reasons in support of the practice:

1. Investors need segmented information to make an intelligent investment decision regarding a diversified company.
   a. Sales and earnings of individual segments enable investors to evaluate the differences between segments in growth rate, risk, and profitability, and to forecast consolidated profits.
   b. Segmented reports help investors evaluate the company’s investment worth by disclosing the nature of a company’s businesses and the relative size of the components.
2. The absence of segmented reporting by a diversified company may put its unsegmented, single product-line competitors at a competitive disadvantage because the conglomerate may obscure information that its competitors must disclose.

The advocates of segmented disclosures appear to have a much stronger case. Many users indicate that segmented data are the most useful financial information provided, aside from the basic financial statements. As a result, the IASB has issued extensive reporting guidelines in this area.

Objective of Reporting Segmented Information

The objective of reporting segmented financial data is to provide information about the **different types of business activities** in which an enterprise engages and the **different**

economic environments in which it operates. Meeting this objective will help users of financial statements do the following.

a. Better understand the enterprise's performance.
b. Better assess its prospects for future net cash flows.
c. Make more informed judgments about the enterprise as a whole.

Basic Principles

Financial statements can be disaggregated in several ways. For example, they can be disaggregated by products or services, by geography, by legal entity, or by type of customer. However, it is not feasible to provide all of that information in every set of financial statements. IFRS requires that general-purpose financial statements include selected information on a single basis of segmentation. Thus, a company can meet the segmented reporting objective by providing financial statements segmented based on how the company's operations are managed. The method chosen is referred to as the **management approach**. **[8] The management approach reflects how management segments the company for making operating decisions.** The segments are evident from the components of the company's organization structure. These components are called **operating segments**.

Identifying Operating Segments

An **operating segment** is a component of an enterprise:

a. That engages in business activities from which it earns revenues and incurs expenses.
b. Whose operating results are regularly reviewed by the company's chief operating decision- maker to assess segment performance and allocate resources to the segment.
c. For which discrete financial information is available that is generated by or based on the internal financial reporting system.

Companies may aggregate information about two or more operating segments only if the segments have the same basic characteristics in each of the following areas.

a. The nature of the products and services provided.
b. The nature of the production process.
c. The type or class of customer.
d. The methods of product or service distribution.
e. If applicable, the nature of the regulatory environment.

After the company decides on the possible segments for disclosure, it makes a quantitative materiality test. This test determines whether the segment is significant enough to warrant actual disclosure. An operating segment is deemed significant and therefore a reportable segment if it satisfies **one or more** of the following quantitative thresholds.

1. Its **revenue** (including sales to both internal and external customers and intersegment sales or transfers) is 10 percent or more of the combined revenue of all the company's

operating segments.

2. The absolute amount of its **profit or loss** is 10 percent or more of the greater, in absolute amount, of **(a)** the combined operating profit of all operating segments that did not incur a loss, or **(b)** the combined loss of all operating segments that did report a loss.
3. Its **identifiable assets** are 10 percent or more of the combined assets of all operating segments.

In applying these tests, the company must consider two additional factors. First, segment data must explain a significant portion of the company's business. Specifically, the segmented results must equal or exceed 75 percent of the combined sales to unaffiliated customers for the entire company. This test prevents a company from providing limited information on only a few segments and lumping all the rest into one category.

Second, the profession recognizes that reporting too many segments may overwhelm users with detailed information. The IASB decided that 10 is a reasonable upper limit for the number of segments that a company must disclose (see Underlying Concepts). [9]

Underlying Concepts

Users of financial statements indicate that multi-segment companies operate diverse businesses that are subject to different opportunities and risks. Segment information provides additional insight about the opportunities and risks of investments and sharpens predictions. Because of its predictive value, providing segment information is of the highest priority.

To illustrate these requirements, assume a company has identified six possible reporting segments, as shown in Illustration 24.7 (euros in thousands).

Segments	Total Revenue (Unaffiliated)	Operating Profit (Loss)	Identifiable Assets
A	€ 100	€10	€ 60
B	50	2	30
C	700	40	390
D	300	20	160
E	900	18	280
F	100	(5)	50
	€2,150	€85	€970

ILLUSTRATION 24.7 Data for Different Possible Reporting Segments

The company would apply the respective tests as follows.

Revenue test: .10 × €2,150 = €215; C, D, and E meet this test.

Operating profit (loss) test: .10 × €90 = €9 (note that the €5 loss is ignored, because the test is based on non-loss segments); A, C, D, and E meet this test.

Identifiable assets tests: .10 × €970 = €97; C, D, and E meet this test.

The reporting segments are therefore A, C, D, and E, assuming that these four segments have enough sales to meet the 75 percent of combined sales test. The 75 percent test is computed as follows.

75% of combined sales test: .75 × €2,150 = €1,612.50. The sales of A, C, D, and E total €2,000 (€100 + €700 + €300 + €900); therefore, the 75 percent test is met.

Measurement Principles

The accounting principles that companies use for segment disclosure need not be the same as the principles they use to prepare the consolidated statements. This flexibility may at first appear inconsistent. But, preparing segment information in accordance with IFRS would be difficult because some IFRS are not expected to be applied at a segment level. Examples include accounting for the cost of company-wide employee benefit plans, and accounting for income taxes in a company that files a consolidated tax return with segments in different tax jurisdictions.

The IASB does not require allocations of joint, common, or company-wide costs solely for external reporting purposes. **Common costs** are those incurred for the benefit of more than one segment and whose interrelated nature prevents a completely objective division of costs among segments. For example, the company president's salary is difficult to allocate to various segments. Allocations of common costs are inherently arbitrary and may not be meaningful. There is a presumption that if companies allocate common costs to segments, these allocations are either directly attributable or reasonably allocable to the segments.

Segmented Information Reported

The IASB requires that an enterprise report the following.

1. **General information about its operating segments.** This includes factors that management considers most significant in determining the company's operating segments and the types of products and services from which each operating segment derives its revenues.
2. **Segment profit and loss and related information.** Specifically, companies must report the following information about each operating segment if the amounts are included in determining segment profit or loss.
   a. Revenues from transactions with external customers.
   b. Revenues from transactions with other operating segments of the same enterprise.
   c. Interest revenue.
   d. Interest expense.
   e. Depreciation and amortization expense.
   f. Unusual items.
   g. Equity in the net income of investees accounted for by the equity method.
   h. Income tax expense or benefit.
   i. Significant non-cash items other than depreciation, depletion, and amortization expense.

3. **Segment assets and liabilities.** A company must report each operating segment's total assets and liabilities.
4. **Reconciliations.** A company must provide a reconciliation of the total of the segments' revenues to total revenues, a reconciliation of the total of the operating segments' profits and losses to its income before income taxes, and a reconciliation of the total of the operating segments' assets and liabilities to total assets and liabilities.
5. **Information about products and services and geographic areas.** For each operating segment not based on geography, the company must report (unless it is impracticable): (1) revenues from external customers, (2) long-lived assets, and (3) expenditures during the period for long-lived assets. This information, if material, must be reported (a) in the enterprise's country of domicile and (b) in each other country.
6. **Major customers.** If 10 percent or more of company revenue is derived from a single customer, the company must disclose the total amount of revenue from each such customer by segment.

Illustration of Disaggregated Information

Illustration 24.8 shows the segment disclosure for **Equinor** (NOR).

Equinor

3 Segments (partial)

Segment data for the year ended 31 December, 2018 is presented below. The measurement basis of segment profit is *Net operating income*. In the table below, deferred tax assets, pension assets and non-current financial assets are not allocated to the segments. Also, the line additions to PP&E, intangibles, and equity accounted investments is excluding movements due to changes in asset retirement obligations.

(in USD million)	E&P Norway	E&P International	MMP	Other	Eliminations	Total
Full year 2018						
Revenues third party, other revenues and other income	588	3,182	75,487	44	0	79,301
Revenues inter-segment	21,877	9,186	291	2	(31,355)	0
Net income/(loss) from equity accounted investments	10	31	16	234	0	291
Total revenues and other income	22,475	12,399	75,794	280	(31,355)	79,593
Purchases (net of inventory variation)	2	(26)	(69,296)	(0)	30,805	(38,515)
Operating, selling, general and administrative expenses	(3,270)	(3,006)	(4,377)	(288)	653	(10,288)
Depreciation, amortisation and net impairment losses	(4,370)	(4,592)	(215)	(72)	0	(9,249)
Exploration expenses	(431)	(973)	0	0	0	(1,404)
Net operating income/(loss)	14,406	3,802	1,906	(79)	103	20,137
Additions to PP&E, intangibles and equity accounted investments	6,947	7,403	331	519	0	15,201
Balance sheet information						

Equity accounted investments	1,102	296	92	1,373	0	2,863
Non-current segment assets	30,762	38,672	5,148	353	0	74,934
Non-current assets, not allocated to segments						8,655
Total non-current assets						86,452

ILLUSTRATION 24.8 Segment Disclosure

Interim Reports

Another source of information for the investor is interim reports. As noted earlier, **interim reports** cover periods of less than one year. The securities exchanges, market regulators, and the accounting profession have an active interest in the presentation of interim information (see Underlying Concepts).

Underlying Concepts

For information to be relevant, it must be available to decision-makers before it loses its capacity to influence their decisions (timeliness). Interim reporting is an excellent example of this concept.

Because of the short-term nature of the information in these reports, there is considerable controversy which general approach companies should employ. One group, which favors the **discrete approach**, believes that companies should treat each interim period as a separate accounting period. Under that protocol, companies would follow the principles for deferrals and accruals used for annual reports. Companies would report accounting transactions as they occur, and expense recognition would not change with the period of time covered.

Another group, which favors the **integral approach**, believes that the interim report is an integral part of the annual report and that deferrals and accruals should take into consideration what will happen for the entire year. In this approach, companies would assign estimated expenses to parts of a year on the basis of sales volume or some other activity base. In general, **IFRS requires companies to follow the discrete approach.** [10]

Interim Reporting Requirements

Generally, companies should use the same accounting policies for both interim and annual reports. They should recognize revenues in interim periods on the same basis as they are recognized for annual periods. For example, if Cedars Corp. uses the percentage-of-completion method as the basis for recognizing revenue on an annual basis, then it should use the percentage-of-completion method for interim reports as well. Also, Cedars should treat costs directly associated with revenues (product costs, such as materials, labor and related fringe benefits and manufacturing overhead) in the same manner for interim reports as for annual reports.

Companies should use the same inventory pricing methods (FIFO, average-cost, etc.) for both interim and annual reports. However, companies may use the gross profit method for interim inventory pricing. But they must disclose the method and adjustments to reconcile with annual inventory.

Discrete Approach

Following the discrete approach, companies record in interim reports revenues and expenses according to the revenue and expense recognition principles. This includes costs and expenses other than product costs (often referred to as period costs). No accruals or deferrals in anticipation of future events during the year should be reported. For example, the cost of a planned major periodic maintenance or overhaul for a company such as **Airbus** (FRA), or other seasonal expenditure that is expected to occur late in the year is not anticipated for interim reporting purposes. The mere intention or necessity of incurring future expenditures is not sufficient to give rise to an obligation.

A company such as **Carrefour** (FRA) may budget certain costs, which it expects to be incurred sporadically during the financial year, such as advertising and employee training costs. Those costs generally are discretionary even though they are planned and tend to recur from year to year. However, recognizing an obligation at the end of an interim financial reporting period for costs that have not yet been incurred is not consistent generally with the definition of a liability.

While year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year, the principles for recognizing assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements. For example, **Wm Morrison Supermarkets plc** (GBR) records losses from inventory write-downs, restructurings, or impairments in an interim period similarly to how it treats these items in the annual financial statements (when incurred). However, if an estimate from a prior interim period changes in a subsequent interim period of that year, the original estimate is adjusted in the subsequent interim period.

Interim Disclosures

IFRS does not require a complete set of financial statements at the interim reporting date. Rather, companies can comply with the requirements by providing condensed financial statements and selected explanatory notes. Because users of interim financial reports also have access to the most recent annual financial report, companies only have to provide explanation of significant events and transactions since the end of the last annual reporting period. Companies should report the following interim data at a minimum.

1. Statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change.
2. Explanatory comments about the seasonality or cyclicality of interim operations.
3. The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.

4. The nature and amount of changes in accounting policies and estimates of amounts previously reported.
5. Issuances, repurchases, and repayments of debt and equity securities.
6. Dividends paid (aggregate or per share) separately for ordinary shares and other shares.
7. Segment information, as required by *IFRS 8*, "Operating Segments."
8. Changes in contingent liabilities or contingent assets since the end of the last annual reporting period.
9. Effect of changes in the composition of the company during the interim period, such as business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations.
10. Other material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period.

If a complete set of financial statements is provided in the interim report, companies comply with the provisions of *IAS 1*, "Presentation of Financial Statements."

Unique Problems of Interim Reporting

IFRS reflects a preference for the discrete approach. However, within this broad guideline, a number of unique reporting problems develop related to the following items.

Income Taxes

Not every dollar of company taxable income may be taxed at the same rate if the tax rate is progressive. This aspect of business income taxes poses a problem in preparing interim financial statements. Should the company use the **annualized approach**, which annualizes income to date and accrues the proportionate income tax for the period to date? Or should it follow the **marginal principle approach**, which applies the lower rate of tax to the first amount of income earned? At one time, companies generally followed the latter approach and accrued the tax applicable to each additional dollar of income.

IFRS requires use of the annualized approach. Income tax expense is recognized in each interim period based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. This approach is consistent with applying the same principles in interim reports that are applied to the annual report; that is, income taxes are assessed on an annual basis. However, amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes. **[11]**[7]

Seasonality

Seasonality occurs when most of a company's sales occur in one short period of the year, while certain costs are fairly evenly spread throughout the year. For example, the natural gas industry has its greatest sales in the winter months. In contrast, the beverage industry has its greatest sales in the summer months.

The problem of seasonality is related to the expense recognition principle in accounting. Generally, expenses are associated with the revenues they create. In a seasonal business, wide fluctuations in profits occur because off-season sales do not absorb the company's fixed costs (for example, manufacturing, selling, and administrative costs that tend to remain fairly constant regardless of sales or production).

To illustrate why seasonality is a problem, assume the information as shown in **Illustration 24.9**.

Selling price per unit	$1
Annual sales for the period (projected and actual) 100,000 units @ $1	$100,000
Manufacturing costs	
Variable	10¢ per unit
Fixed	20¢ per unit or $20,000 for the year
Non-manufacturing costs	
Variable	10¢ per unit
Fixed	30¢ per unit or $30,000 for the year

ILLUSTRATION 24.9 Data for Seasonality Example

Illustration 24.10 shows sales for four quarters and the year (projected and actual).

		Percent of Sales
1st Quarter	$ 20,000	20%
2nd Quarter	5,000	5
3rd Quarter	10,000	10
4th Quarter	65,000	65
Total for the year	$100,000	100%

ILLUSTRATION 24.10 Sales Data for Seasonality Example

Under the present accounting framework, the income statements for the quarters might be as shown in **Illustration 24.11**.

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Year
Sales	$20,000	$ 5,000	$10,000	$65,000	$100,000
Manufacturing costs					
Variable	(2,000)	(500)	(1,000)	(6,500)	(10,000)
Fixed[a]	(4,000)	(1,000)	(2,000)	(13,000)	(20,000)
	14,000	3,500	7,000	45,500	70,000
Non-manufacturing costs					
Variable	(2,000)	(500)	(1,000)	(6,500)	(10,000)
Fixed[b]	(7,500)	(7,500)	(7,500)	(7,500)	(30,000)
Income	$ 4,500	$(4,500)	$ (1,500)	$31,500	$ 30,000

[a] The fixed manufacturing costs are inventoried, so that equal amounts of fixed costs do not appear during each quarter.

[b] The fixed non-manufacturing costs are not inventoried, so equal amounts of fixed costs appear during each quarter.

ILLUSTRATION 24.11 Interim Net Income for Seasonal Business—Discrete Approach

An investor who uses the first quarter's results might be misled. If the first quarter's earnings are $4,500, should this figure be multiplied by four to predict annual earnings of $18,000? Or, if first-quarter sales of $20,000 are 20 percent of the predicted sales for the year, would the net income for the year be $22,500 ($4,500 × 5)? Both figures are obviously wrong. And the investor may become even more confused after the second quarter's results are reported.

The problem with the conventional approach is that the fixed non-manufacturing costs are not charged in proportion to sales. Some enterprises have avoided this problem by making all fixed non-manufacturing costs follow the sales pattern, as shown in **Illustration 24.12**.

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Year
Sales	$20,000	$ 5,000	$10,000	$65,000	$100,000
Manufacturing costs					
Variable	(2,000)	(500)	(1,000)	(6,500)	(10,000)
Fixed	(4,000)	(1,000)	(2,000)	(13,000)	(20,000)
	14,000	3,500	7,000	45,500	70,000
Non-manufacturing costs					
Variable	(2,000)	(500)	(1,000)	(6,500)	(10,000)
Fixed	(6,000)	(1,500)	(3,000)	(19,500)	(30,000)
Income	$ 6,000	$ 1,500	$ 3,000	$19,500	$ 30,000

ILLUSTRATION 24.12 Interim Net Income for Seasonal Business—Integral Approach

This approach solves some of the problems of interim reporting: Sales in the first quarter are 20 percent of total sales for the year, and net income in the first quarter is 20 percent of total income. In this case, as in the previous example, the investor cannot rely on multiplying any given quarter by four but can use comparative data or can rely on some estimate of sales in relation to income for a given period.

The greater the degree of seasonality a company experiences, the greater the possibility of distortion. Because there are no definitive guidelines for handling such items as the fixed non-manufacturing costs, variability in income can be substantial. To alleviate this problem, IFRS requires companies subject to material seasonal variations to both disclose the seasonal nature of their business and consider supplementing their interim reports with information for 12-month periods ended at the interim date, for the current and preceding years.

The two illustrations highlight the difference between the **discrete** and **integral** approaches. Illustration 24.11 represents the discrete approach, in which the fixed non-manufacturing expenses are expensed as incurred. Illustration 24.12 shows the integral approach, in which expenses are charged to expense on the basis of some measure of activity.

Evolving Issue

It's Faster But Is It Better?

The profession has developed some rules for interim reporting, but much still has to be done. As yet, it is unclear whether the discrete or the integral method, or some combination of the two, will prevail. Discussion also persists about the independent auditor's involvement in interim reports. Many auditors are reluctant to express an opinion on interim financial information, arguing that the data are too tentative and subjective. On the other hand, more people are advocating some examination of interim reports. As a compromise, auditors generally perform a review of interim financial information. Such a review, which is much more limited in its procedures than the annual audit, provides some assurance that the interim information appears to be in accord with relevant standards.[8]

Analysts and investors want financial information as soon as possible, before it's old news. We may not be far from a continuous database system in which company financial records can be accessed via the Internet. Investors might be able to access a company's financial records whenever they wish and put the information in the format they need. Thus, they could learn about sales slippage, cost increases, or earnings changes as they happen, rather than waiting until after the quarter has ended. A step in this direction is the mandate by the U.S. Securities and Exchange Commission (SEC) for companies to file their financial statements electronically.

The SEC also believes that timeliness of information is extremely important. It gives large public companies just 45 days to complete and disseminate their annual reports. Quarterly reports must be done within 40 days of the close of the quarter, and company executives and shareholders with more than 10 percent of a company's outstanding shares now have just two days to disclose their sale or purchase of shares. Furthermore, the SEC encourages companies to post current, quarterly, and annual reports on their websites—or explain why they don't. The postings would have to be made by the day the company submits the information to the U.S. SEC. A steady stream of information from the company to the investor could be very positive because it might alleviate management's continual concern with short-run interim numbers.

In a recent speech, Hans Hoogervorst, chair of the IASB, made the following comments about the relationship between short-termism and accounting standards:

> "I agree with everybody who thinks that the financial markets are plagued by short-termism.
>
> Management can be subject to the temptations of short-termism. Although executive pay is often linked to a company's financial performance, all too often this performance is measured using unbalanced non-GAAP numbers, defined by management itself. Moreover, because the median tenure for CEOs is no longer than five years, management can be tempted to boost a company's short-term performance at the expense of long-term results.
>
> Given these incentives for short-termism, high-quality accounting standards are essential. Accounting standards that aim to reflect economic reality as closely as possible help the company and its investors to navigate challenges in a timely fashion."

While some are calling for the elimination of all interim reporting requirements in response to the negative consequences of short-termism, others are calling for a common sense approach, encouraging standard-setters to consider both costs and benefits. In their view, regulators and standard-setters should be judicious when establishing disclosures that are mandatory every reporting period, and that the hurdle should be high for such requirements.

Sources: D. Benoit, "Time to End Quarterly Reports, Law Firm Says," *Wall Street Journal* (August 19, 2015); PricewaterhouseCoopers, "The Interim Reporting Model: Time to Get Back to Basics," *Point of View* (November 2014); and Hans Hoogervorst, "Accounting Standards and the Long Term," Speech at the 9th Symposium of Accounting Research at *Autorité des Normes Comptables* (December 19, 2019).

Auditor's and Management's Reports

LEARNING OBJECTIVE 3

Identify the major disclosures in the auditor's report and management's responsibilities for the financial statements.

Auditor's Report

Another important source of information often overlooked is the **auditor's report**. An **auditor** is an accounting professional who conducts an independent examination of a company's accounting data.

Audit Opinion

If satisfied that the financial statements present the financial position, results of operations, and cash flows fairly in accordance with IFRS, the auditor expresses an **unmodified opinion**. An example is shown in **Illustration 24.13**.[9]

Puma SE

Auditor’s Report (in part)

Audit Opinions

We have audited the consolidated financial statements of PUMA SE, Herzogenaurach, and its subsidiaries (the Group), which comprise the consolidated balance sheet as at 31 December 2018, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the financial year from 1 January to 31 December 2018 as well as the notes to the consolidated financial statements, including a summary of significant accounting policies. In addition, we have audited the combined management report of PUMA SE for the financial year from 1 January to 31 December 2018.

In our opinion, on the basis of the knowledge obtained in the audit...

- the accompanying consolidated financial statements comply, in all material respects, with the International Financial Reporting Standards (IFRS) as adopted by the EU, and the additional requirements of German commercial law pursuant to Section 315e (1) German Commercial Code (HGB) and, in compliance with these requirements, give a true and fair view of the assets, liabilities, and financial position of the Group as at 31 December 2018, and of its financial performance for the financial year from 1 January to 31 December 2018, and
- the accompanying combined management report as a whole provides an appropriate view of the Group’s position. In all material respects, this combined management report is consistent with the consolidated financial statements, complies with German legal requirements and appropriately presents the opportunities and risks of future development. Our audit opinion on the combined management report does not cover the content of the statement on corporate governance and the corporate governance report specified in Chapter “Corporate Governance Report including the Statement on Corporate Governance pursuant to § 289f and § 315d HGB” of the combined management report.

Pursuant to Section 322 (3) Sentence 1 German Commercial Code (HGB), we declare that our audit has not led to any reservations relating to the legal compliance of the consolidated financial statements and of the combined management report.

Basis for the Audit Opinions

We conducted our audit of the consolidated financial statements and of the combined management report in accordance with Section 317 German Commercial Code (HGB) and the EU Audit Regulation (No. 537 / 2014; referred to subsequently as “EU Audit Regulation”) and in compliance with German Generally Accepted Standards for Financial Statement Audits promulgated by the Institut der Wirtschaftsprüfer (IDW). Our responsibilities under those requirements and principles are further described in the “Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements and of the Combined Management Report" section of our auditor's report. We are independent of the group entities in accordance with the requirements of European law and German commercial and professional law, and we have fulfilled our other German professional responsibilities in accordance with these requirements. In addition, in accordance with Article 10 (2) Point (f) of the EU Audit Regulation, we declare that we have not provided non-audit services prohibited under Article 5 (1) of the EU Audit Regulation. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions on the consolidated financial statements and on the combined management report.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements and of the Combined Management Report

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and whether the combined management report as a whole provides an appropriate view of the Group's position and, in all material respects, is consistent with the consolidated financial statements and the knowledge obtained in the audit, complies with the German legal requirements and appropriately presents the opportunities and risks of future development, as well as to issue an auditor's report that includes our audit opinions on the consolidated financial statements and on the combined management report.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Section 317 German Commercial Code (HGB) and the EU Audit Regulation and in compliance with German Generally Accepted Standards for Financial Statement Audits promulgated by the Institut der Wirtschaftsprüfer (IDW) will always detect a material misstatement. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements and this combined management report.

OTHER LEGAL AND REGULATORY REQUIREMENTS

Further information pursuant to Article 10 of the EU Audit Regulation

We were elected as group auditor by the annual general meeting on 12 April 2018. We were engaged by the Supervisory Board on 24 October 2018. We have been the group auditor of PUMA SE, Herzogenaurach, without interruption since the financial year 2012.

We declare that the audit opinions expressed in this auditor's report are consistent with the additional report to the audit committee pursuant to Article 11 of the EU Audit Regulation (long form audit report).

GERMAN PUBLIC AUDITOR RESPONSIBLE FOR THE ENGAGEMENT

The German Public Auditor responsible for the engagement is Stefan Otto.

Munich, 30 January 2019

Deloitte GmbH
Wirtschaftsprüfungsgesellschaft

Christof Stadter
Wirtschaftsprüfer
[German Public Auditor]

Stefan Otto
Wirtschaftsprüfer
[German Public Auditor]

Source: The full 2018 auditor's report for Puma can be accessed at the company's website; see pages 197-201.

ILLUSTRATION 24.13 Auditor's Report

In preparing the report, the auditor followed these reporting standards.

1. The report states whether the financial statements are in accordance with the financial reporting framework (IFRS) and describes the responsibilities of the directors and auditors with respect to the financial statements.
2. The report identifies those circumstances in which the company has not consistently observed such policies in the current period in relation to the preceding period.
3. Users are to regard the informative disclosures in the financial statements as reasonably adequate unless the report states otherwise.
4. The report contains either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. When the auditor cannot express an overall opinion, the report should state the reasons. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility being taken.

In most cases, the auditor issues a standard **unmodified or clean opinion**, as shown in Illustration 24.13. That is, the auditor expresses the opinion that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with accepted accounting principles.

Certain circumstances, although they do not affect the auditor's unmodified opinion, may require the auditor to add an explanatory paragraph to the audit report. Some of the more important circumstances are as follows.

1. **Going concern.** The auditor must evaluate whether there is substantial doubt about the entity's **ability to continue as a going concern** for a reasonable period of time, taking into consideration all available information about the future. (Generally, the future is at least, but not limited to, 12 months from the end of the reporting period.) If substantial doubt exists about the company's future, the auditor adds to the report an explanatory note describing the potential problem.
2. **Lack of consistency.** If a company has changed accounting policies or the method of their application in a way that has a material effect on the comparability of its financial statements, the auditor should refer to the change in an explanatory paragraph of the report. Such an explanatory paragraph should identify the nature of the change and refer readers to the note in the financial statements that discusses the change in detail. The auditor's concurrence with a change is implicit unless the auditor takes exception to the change in expressing an opinion as to fair presentation in conformity with accepted accounting principles (IFRS).
3. **Emphasis of a matter.** The auditor may wish to emphasize a matter regarding the financial statements but nevertheless intends to express an unqualified opinion. For

example, the auditor may wish to emphasize that the entity is a component of a larger business enterprise or that it has had significant transactions with related parties. The auditor presents such explanatory information in a separate paragraph of the report.

In some situations, however, the auditor expresses a **modified opinion**. A modified opinion can be either (1) a **qualified** opinion, (2) an **adverse** opinion, or (3) a **disclaimed** opinion.

A **qualified opinion** contains an exception to the standard opinion. Ordinarily, the exception is not of sufficient magnitude to invalidate the statements as a whole; if it were, an adverse opinion would be rendered. The circumstances in which the auditor may deviate from the standard unqualified report on financial statements are as follows.

1. The scope of the examination is limited or affected by conditions or restrictions.
2. The statements do not fairly present financial position or results of operations because of:
    a. Lack of conformity with accepted accounting principles and standards.
    b. Inadequate disclosure.

If confronted with one of the situations noted above, the auditor must offer a qualified opinion. A qualified opinion states that, except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with accepted accounting principles.

Illustration 24.14 shows an example of an auditor's report with a modified opinion—in this case, a qualified opinion of **Helio Company** (USA). The auditor modified the opinion because the company used an accounting policy at variance with accepted accounting principles.

Helio Company

Independent Auditor's Report

(Same first and second paragraphs as the standard report)

Helio Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accepted accounting principles. If these lease obligations were capitalized, property would be increased by $1,500,000 and $1,300,000, long-term debt by $1,400,000 and $1,200,000, and retained earnings by $100,000 and $50,000 as of December 31, in the current and prior year, respectively. Additionally, net income would be decreased by $40,000 and $30,000 and earnings per share would be decreased by $.06 and $.04, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Helio Company, and the results of its operations and its cash flows for the years then ended in conformity with accepted accounting principles.

ILLUSTRATION 24.14 Auditor's Report with Qualified Opinion

An **adverse opinion** is required in any report in which the exceptions to fair presentation are so material that in the independent auditor's judgment, a qualified opinion is not justified. In such a case, the financial statements taken as a whole are not presented in accordance with IFRS. Adverse opinions are rare because most companies change their accounting to conform with IFRS. Market regulators will not permit a company listed on an exchange to have an adverse opinion.

A **disclaimer of an opinion** is appropriate when the auditor has gathered so little information on the financial statements that no opinion can be expressed.

Key Audit Matters

In many countries, auditors are also required to include in their audit report "key audit matters." **Key audit matters (KAMs)** are defined as "those matters that, in the auditor's professional judgement, were of the most significance in the audit of the financial statement of the current period."[10] **Illustration 24.15** presents a KAM discussion from the audit report of **Puma** (DEU).

Puma SE

Key Audit Matter Discussion (in part)

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements for the financial year from 1 January to 31 December 2018. These matters were addressed in the context of our audit of the consolidated financial statements as a whole and in forming our audit opinion thereon; we do not provide a separate audit opinion on these matters.

In the following we present the key audit matters we have determined in the course of our audit:

1. Recoverability of goodwill
2. Recoverability of the Cobra brand

Our presentation of these key audit matters has been structured as follows:

a. Description (including reference to corresponding information in the consolidated financial statements)

b. Auditor's response

Recoverability of goodwill

a. The consolidated financial statements of PUMA SE show goodwill in the amount of mEUR 245.7 corresponding to approximately 7.7% of the consolidated balance sheet total or 14.3% of the group equity.

Each financial year or in case of respective signs of impairment, goodwill is subject to impairment tests. The impairment tests are performed by PUMA SE by applying the "discounted cash flow method". The valuation is based on the present values of the future cash flows. The company's valuation model is based on future cash flows, which are in turn based on the effective three-year plan and valid at the date the impairment test. This detailed planning phase is extended with the assumption of long-term growth rates. The discounting is performed using the weighted average cost of capital (WACC). Here, the realizable amount is determined on the basis of the value in use and a possible need for impairment is determined by comparing the value in use with the carrying amount.

The outcome of this valuation highly depends on the legal representatives' assessment of future cash flows, the WACC rate applied and the long-term growth rate and therefore involves uncertainties and discretion. Thus, the assessment of the recoverability of the goodwill was classified as a key audit matter within the scope of our audit.

Information on the goodwill, provided by the legal representatives, is disclosed in Chapter 2 "Significant Consolidation, Accounting and Valuation Principles" and in Chapter 10 "Intangible Assets" of the notes to the consolidated financial statements.

b. Within the scope of our risk-oriented audit, we gained an understanding of the systematic approach applied when performing the impairment test. We satisfied ourselves, that the valuation model used adequately presents the requirements of the relevant standards, whether the necessary input data are completely and accurately determined and whether the calculations within the model are performed correctly. We satisfied ourselves of the appropriateness of the future cash flows used for the computation by reconciling these cash flows particularly with the effective three-year plan as well as by interviewing the legal representatives or persons appointed by them with regard to the material assumptions underlying this plan. In addition, we performed a critical assessment of the plan under consideration of general and industry-specific market expectations.

Since a material portion of the value in use results from the forecasted cash flows for the period after the three-year plan (phase of perpetuity), we in particular critically assessed the sustainable growth rate used within the perpetuity phase by means of general and industry-specific market expectations. Since relatively low changes of the discounting rate may materially affect the amount of the realizable value, we have also checked the parameters used when determining the WACC rate involving internal valuation experts from the financial advisory sector and reproduced the computation scheme.

Due to the material significance and taking into account the fact that the assessment of the goodwill also depends on the economic framework conditions that cannot be influenced by the Group, we performed in addition a critical assessment of the sensitivity analyses performed by PUMA SE for the cash-generating units (so-called CGUs) with low headroom (present values compared to the carrying amount) in order to be able to assess a possible impairment risk in case of change of a material valuation assumption.

Source: The full 2018 auditor’s report for Puma can be accessed at the company’s website; see pages 197-199.

ILLUSTRATION 24.15 Key Audit Matters

According to audit standards, for each KAM that is included in the audit report, the auditor will describe why the matter was considered to be significant and how it was addressed during the audit. The goal of including KAMs in an audit report is to enhance the communication value of the report. In Puma’s audit report, the KAM presented is related to goodwill. Many of the accounting topics appearing in this text, including revenue recognition, asset impairments, income taxes, inventory, and contingent liabilities, commonly appear as KAMs.

The audit report should provide useful information to the investor. One investment banker noted, “Probably the first item to check is the auditor’s opinion to see whether or not it is a clean one—‘in conformity with accepted accounting principles’—or is qualified in regard to differences between the auditor and company management in the accounting treatment of some major item, or in the outcome of some major litigation.”

What Do the Numbers Mean?

Heart of the Matter

Financial disclosure is one of a number of institutional features that contribute to healthy security markets. In fact, a recent study of disclosure and other mechanisms (such as civil lawsuits and criminal sanctions) found that good disclosure is the most important contributor to a vibrant market. The study, which compared disclosure and other legal and regulatory elements across 49 countries, found that countries with the best disclosure laws have the biggest securities markets.

Countries with more successful market environments also tend to have regulations that make it relatively easy for private investors to sue companies that provide bad information. While criminal sanctions can be effective in some circumstances, disclosure and other legal and regulatory elements encouraging good disclosure are the most important determinants of highly liquid and deep securities markets. And it does not matter whether we are talking about securities exchanges or bond markets. In fact, at a recent bond dealers' conference, underwriters were told it is best to walk away from deals that do not measure up with respect to the disclosure standards established by regulators.

These findings hold for nations in all stages of economic development, with particular importance for nations that are in the early stages of securities regulation. In addition, countries with fewer market protections likely will benefit the most from adoption of international standards for market regulation and disclosure. The lesson: Disclosure is good for your market.

Sources: Rebecca Christie, "Study: Disclosure at Heart of Effective Securities Laws," *Wall Street Journal Online* (August 11, 2003); and L. Hail, C. Leuz, and P. Wysocki, "Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part I): Conceptual Underpinnings and Economic Analysis," *Accounting Horizons* (September 2010). See also N. Trentmann, "Financial Reports: Could Be Better, Says U.K. Regulator," *Wall Street Journal* (October 23, 2017).

Management's Reports

Management Commentary

Management commentary helps in the interpretation of the financial position, financial performance, and cash flows of a company. For example, a company such as **Ahold Delhaize** (NLD/BEL) may present, outside the financial statements, a financial review by management that describes and explains the main features of the company's financial performance and financial position, and the principal uncertainties it faces. Such a report may include a review of:

- The main factors and influences determining financial performance, including changes in the environment in which the entity operates, the entity's response to those changes and their effect, and the company's policy for investment to maintain and enhance financial performance, including its dividend policy;
- The company's sources of funding and its targeted ratio of liabilities to equity; and

- The company's resources not recognized in the statement of financial position in accordance with IFRS.

Such commentary also provides an opportunity to understand management's objectives and its strategies for achieving those objectives. Users of financial reports, in their capacity as capital providers, routinely use the type of information provided in management commentary as a tool for evaluating an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives (see **Underlying Concepts**).

Underlying Concepts

The IASB Conceptual Framework notes that management knows more about the company than users and therefore can increase the usefulness of financial information by identifying significant transactions that affect the company and by explaining their financial impact.

For many companies, management commentary is already an important element of their communication with the capital markets, supplementing as well as complementing the financial statements. Management commentary encompasses reporting that is described in various jurisdictions as management's discussion and analysis (MD&A), operating and financial review (OFR), or management's report.

Illustration 24.16 presents an excerpt from the MD&A section of **Lectra**'s (FRA) annual report.

Lectra

Management Discussion and Analysis (in part)

4. RISK FACTORS - INTERNAL CONTROL AND RISK MANAGEMENT PROCEDURES

This chapter describes the main risks facing the Group with regards to the specific characteristics of its business, of its structure and its organization, of its strategy and its business model. It further describes how the Group manages and prevents these risks, depending on their nature.

4.1 Risk factors

For internal control and risk management to be effective, the Group needs to be able to identify and assess the risks to which it is subject, namely the possible occurrence of an event whose consequences could affect the Company’s human capital, assets, environment, goals, together with its activity, financial condition, financial results, ability to achieve its goals, or reputation.

The risk factors are divided into two main categories: risks relating to the environment in which the Group operates, and operational risks relating to its activity.

4.1.1 Risks related to the environment in which the Group operates

4.1.1.1 Macroeconomic and geopolitical environment

The solutions marketed by the Group represent a sometimes sizable investment for its customers. Decisions depend in part on the macroeconomic environment and on the state of the sectors of activity in which the customers operate. Customers could scale back or defer their investment decisions when global economic growth slows or when a particular sector suffers a downturn or is in crisis. The Group is consequently exposed to the global economic cycles. The economic development of the countries where the Group operates is mixed, and for some of them their political, economic and monetary situation either has deteriorated or is at risk of doing so.

The key factor protecting the Group against changes in the environment in which the Group operates is its business model, and in particular:

- a distribution of business activity over market sectors and geographic markets with cycles that are different from each other, and the very large number of customers throughout the world;
- a balanced revenue mix between revenues from new systems sales, the Company’s growth driver, and revenues from recurring contracts, consumables and parts that provide a cushion in periods of difficult economic conditions.

4.1.1.2 Market risks

Because of its international presence, foreign exchange risk is the main market risk to which the Group is exposed.

Specific foreign exchange risks

The Group is exposed to financial risks resulting from variations in certain currencies against the euro, a substantial proportion of its revenues being denominated in these different currencies.

The impact of these fluctuations on the Group's activity and financial statements is especially significant since the site where final assembly and testing of the equipment it produces and markets takes place, is located in France, and since most of its subcontractors are located in the Eurozone.

Nearly all foreign-currency positions in the Company's statement of financial position are hedged by forward sales and purchases of currencies.

Stock market risks

The Group holds no interests in listed companies other than its own shares held under a Liquidity Agreement (see note 15.2 to the consolidated financial statements), or more generally under the new share repurchase program submitted for approval by the Shareholders' Meeting of April 30, 2019 (see chapter 10). At December 31, 2018, the Group held 0.1% of its own shares in treasury, solely in the framework of the Liquidity Agreement. Accordingly, it is not subject to stock market risk.

4.1.1.3 Risks related to the effects of climate change

Given its activity, and because of the concentration of its industrial operations at its Bordeaux-Cestas site, the Company does not consider the risks related to the effects of climate change to be material. However, the Company cannot exclude that, in some parts of the world, extreme climate events could have an impact on its customers, their activity and their investment decisions. This risk is minimized, however, by the location of the Group's activity across the entire world.

ILLUSTRATION 24.16 Management's Discussion and Analysis

Alternative Performance Measures

Company management often develops performance measures that are used to evaluate the financial position and performance of the entity and its various components. Some of the measures are based on financial statement items that are defined and required by IFRS. For example, management may regularly review the ratio of debt to equity to gain insight into how the financial leverage of the entity is changing. However, management may also develop measures that do not rely solely on IFRS-defined financial statement items, such as a revenue growth measure based on constant currency, to remove the impact on the change in revenue caused by currency exchange rate changes. Measures not based solely on IFRS-defined measures are referred to as **alternative (or management) performance measures**.

Many companies include these measures in their management commentary because they believe it provides financial statement users with additional insight on how the company is being managed and how it is performing. Current best practice is to provide discussion of each alternative measure that explains how it is calculated, why it is useful to management, and how it is reconciled to the relevant information in the financial statements. Illustration 24.17 presents a selection of the alternative performance measures reported by **Marks and Spencer plc** (GBR).

Marks and Spencer plc

Alternative Performance Measures (in part)

The Group tracks a number of alternative performance measures in managing its business, which are not defined or specified under the requirements of IFRS because they exclude amounts that are included in, or include amounts that are excluded from, the most directly comparable measure calculated and presented in accordance with IFRS, or are calculated using financial measures that are not calculated in accordance with IFRS.

The Group believes that these alternative performance measures, which are not considered to be a substitute for or superior to IFRS measures, provide stakeholders with additional helpful information on the performance of the business. These alternative performance measures are consistent with how the business performance is planned and reported within the internal management reporting to the Board. Some of these alternative performance measures are also used for the purpose of setting remuneration targets.

These alternative performance measures should be viewed as supplemental to, but not as a substitute for, measures presented in the consolidated financial information relating to the Group, which are prepared in accordance with IFRS. The Group believes that these alternative performance measures are useful indicators of its performance. However, they may not be comparable to similarly-titled measures reported by other companies due to differences in the way they are calculated.

APM	Closest equivalent statutory measure	Reconciling items to statutory measure	Definition and purpose
Management gross margin	Gross profit margin	Certain downstream logistics costs	Where referred to throughout the Annual Report, management gross margin is calculated as gross profit on a management basis divided by revenue. The gross profit used in this calculation is based on an internal measure of margin rather than the statutory margin, which excludes certain downstream logistics costs. This is a key internal management metric for assessing category performance.
Net debt	None	Reconciliation of debt – Note 27	Net debt comprises total borrowings (bank, bonds and finance lease liabilities net of accrued interest), net derivative financial instruments that hedge the debt and the Scottish Limited Partnership liability to the Marks and Spencer UK pension scheme less cash, cash equivalents and unlisted and short-term investments.

			This measure is a good indication of the strength of the Group's balance sheet position and is widely used by credit rating agencies.
Free cash flow	Net cash inflow from operating activities	See Financial Review	The cash generated from the Group's operating activities less capital expenditure and interest paid. This measure shows the cash retained by the Group in the year.

ILLUSTRATION 24.17 Alternative Performance Measures

Some companies use the management commentary section of the annual report to disclose company efforts in the area of sustainability. An excerpt from M&S's annual report is presented in **Illustration 24.18**.

Marks and Spencer plc

Plan A Review

Plan A is a multi-year sustainability transformation plan that has been updated several times (2010, 2014 and 2017) to reflect the evolution of our business and the risks and opportunities that social and environmental issues pose for us.

As we go through our business transformation we are currently updating Plan A to reflect our new structures and commercial priorities. This process is not yet complete but as in previous years we are publishing datasets on our most material issues in our 2019 Plan A Performance update.

These datasets show a mixed performance this year, reflecting a period of considerable change across the business. We also offer an audit trail where we highlight existing commitments that we know already we will not be pursuing in the future. Leadership on social and environmental issues remains central to our promise to our customers and colleagues. Once our current comprehensive review of Plan A is completed we will publish our new approach.

Our actions are aligned in support of the United Nations Sustainable Development Goals. Further details about Plan A, our policies, performance and activities can be found online at: marksandspencer.com/plana

Our Goals:

- Places: To help transform 1,000 communities.
- People: To help 10 million people live happier healthier lives.
- Planet: To become a zero-waste business.

Plan A Measurements

Places:

- Transforming Communities: 10 new communities engaged as part of our Helping to Transform Communities Initiative.
- Volunteering Hours: 47,218 hours of work-time volunteering across the UK and Republic of Ireland
- Work Placements: 2,554 to people from disadvantaged groups in the community.

People:

- Empowerment: 83% of our colleagues feel that they are trusted and have the freedom to perform their role effectively.
- Engagement: 81% of our colleagues feel proud to work at M&S and enjoy what they do.

- Enablement: 76% of our colleagues feel that they have the right processes, support and tools to do their job well.

Planet:

- Packaging Recycled: 70% of all M&S product packaging that ends up with customers is classified as being widely recycled in the UK.
- Waste Sent to Landfill: Zero of the waste generative by our stores, offices, and warehouses was sent to the landfill.
- M&S Greenhouse Gas Emissions: 360,000 tons of CO2 emissions down 16% from last year and down 75% since 2006/2007.

ILLUSTRATION 24.18 Sustainability Reporting

Additional reporting on sustainability is important because it indicates a company's level of social responsibility and can provide insights about potential obligations that are reported in the financial statements.

While there are no formal IFRS requirements for management commentary, the IASB has issued a practice statement that offers a non-binding framework and limited guidance on its application, which can be adapted to the legal and economic circumstances of individual jurisdictions. While the statement is focused on publicly traded entities, to the extent that the framework is deemed applicable, it may be a useful tool for non-exchange traded entities, for example, privately held and state-owned enterprises.[11]

Management's Responsibilities for Financial Statements

Management is responsible for preparing the financial statements and establishing and maintaining an effective system of internal controls. The auditor provides an independent assessment of whether the financial statements are prepared in accordance with IFRS (see the audit opinion in Illustration 24.13). An example of the type of disclosure that public companies are now making is shown in **Illustration 24.19**.

Wm Morrison Supermarkets plc

Statement of Directors' responsibilities in respect of the Annual Report and Financial Statements (in part)

The Directors are responsible for preparing the Annual Report and the Financial Statements in accordance with applicable law and regulation.

Company law requires the Directors to prepare financial statements for each financial period. Under that law the Directors have prepared the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and Company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards, comprising FRS 101 'Reduced Disclosure Framework', and applicable law). Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and Company and of the profit or loss of the Group and Company for that period. In preparing the financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- state whether applicable IFRSs as adopted by the European Union have been followed for the Group financial statements, and United Kingdom Accounting Standards, comprising FRS 101, have been followed for the Company financial statements, subject to any material departures disclosed and explained in the financial statements;
- make judgements and accounting estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group and Company's transactions and disclose with reasonable accuracy at any time the financial position of the Group and Company and enable them to ensure that the financial statements and the Directors' remuneration report comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

The Directors are also responsible for safeguarding the assets of the Group and Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the Group and Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The Directors consider that the Annual Report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group and Company's position and performance, business model and strategy. ...

Assessment of whether the Annual Report is fair, balanced and understandable

As required by the Code, the Directors confirm that they consider that the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy.

When arriving at this position the Board was assisted by a number of processes including the following:

- the Annual Report is drafted by appropriate senior management with overall co-ordination by the Chief Financial and Commercial Officer to ensure consistency across sections;
- an extensive verification process is undertaken to ensure factual accuracy; and
- comprehensive reviews of drafts of the report are undertaken by members of the Executive Committee and other senior management; and the final draft is reviewed by the Audit Committee prior to consideration by the Board.

Responsibility statement We confirm that to the best of our knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Group and its subsidiaries included in the consolidation as a whole; and
- the Strategic report includes a fair review of the development of the business and the position of the Group and its subsidiaries included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

12 March 2019

ILLUSTRATION 24.19 Report on Management's Responsibilities

Current Reporting Issues

LEARNING OBJECTIVE 4

Describe other reporting issues related to implementation of the full disclosure principle.

Reporting on Financial Forecasts and Projections

In recent years, the investing public's demand for more and better information has focused on disclosure of company expectations for the future.[12] These disclosures take one of two forms:[13]

- **Financial forecasts.** A **financial forecast** is a set of prospective financial statements that present, to the best of the responsible party's knowledge and belief, a company's expected financial position, results of operations, and cash flows. The responsible party bases a financial forecast on conditions it expects to exist and the course of action it expects to take.

- **Financial projections.** **Financial projections** are prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more *hypothetical assumptions*, an entity's expected financial position, results of operations, and cash flows. The responsible party bases a financial projection on conditions it expects *would* exist and the course of action it expects *would* be taken, given one or more hypothetical assumptions.

The difference between a financial forecast and a financial projection is clear-cut: A forecast provides information on what is **expected** to happen, whereas a projection provides information on what **might** take place but is not necessarily expected to happen.

Whether companies should be required to provide financial forecasts is the subject of intensive discussion with journalists, company executives, market regulators, financial analysts, accountants, and others. Predictably, there are strong arguments on either side. Listed below are some of the arguments.

Arguments for requiring published forecasts:

1. Investment decisions are based on future expectations. Therefore, information about the future facilitates better decisions.
2. Companies already circulate forecasts informally. This situation should be regulated to ensure that the forecasts are available to all investors.
3. Circumstances now change so rapidly that historical information is no longer adequate for prediction.

Arguments against requiring published forecasts:

1. No one can predict the future. Therefore, forecasts will inevitably be wrong. Worse, they may mislead if they convey an impression of precision about the future.
2. Companies may strive only to meet their published forecasts, thereby failing to produce results that are in the shareholders' best interest.
3. If forecasts prove inaccurate, there will be recriminations and probably legal actions.[14]
4. Disclosure of forecasts will be detrimental to organizations because they can be read not only by investors, but also by competitors (foreign and domestic).

Auditing standards establish guidelines for the preparation and presentation of financial forecasts and projections.[15] They require accountants to provide (1) a summary of significant assumptions used in the forecast or projection and (2) guidelines for minimum presentation.

To encourage management to disclose prospective financial information, some market regulators have established a **safe harbor rule**. It provides protection to a company that presents an erroneous forecast, as long as the company prepared the forecast on a reasonable basis and disclosed it in good faith.[16] However, many companies note that the safe harbor rule does not work in practice, since it does not cover oral statements, nor has it prevented investor lawsuits.

What Do the Numbers Mean?

Global Forecasts

Great Britain permits financial forecasts, and the results have been fairly successful. Some significant differences do exist between the English business and legal environments, and those of other countries. The British system, for example, does not permit litigation on forecasted information, and a solicitor (lawyer) is not permitted to work on a contingent-fee basis. A typical British forecast adapted from a construction company's report to support a public offering of shares is as follows.

> Profits have grown substantially over the past 10 years and directors are confident of being able to continue this expansion.... While the rate of expansion will be dependent on the level of economic activity in Ireland and England, the group is well structured to avail itself of opportunities as they arise, particularly in the field of property development, which is expected to play an increasingly important role in the group's future expansion.
>
> Profits before taxation for the half year ended 30th June were 402,000 pounds. On the basis of trading experiences since that date and the present level of sales and completions, the directors expect that in the absence of unforeseen circumstances, the group's profits before taxation for the year to 31st December will be not less than 960,000 pounds.
>
> No dividends will be paid in respect of the current year. In a full financial year, on the basis of above forecasts (not including full year profits) it would be the intention of the board, assuming current rates of tax, to recommend dividends totaling 40% (of after-tax profits), which will be payable in the next two years.

A general narrative-type forecast might appear as follows.

> On the basis of promotions planned by the company for the second half of the fiscal year, net earnings for that period are expected to be approximately the same as those for the first half of the fiscal year, with net earnings for the third quarter expected to make the predominant contribution to net earnings for the second half of the year.

As indicated, the general version is much less specific in its forecasted information.

But such differences probably could be overcome if influential interests cooperated to produce an atmosphere conducive to quality forecasting. What do you think? As an investor, would you prefer the more specific forecast?

Source: See "A Case for Forecasting—The British Have Tried It and Find That It Works," *World* (New York: Peat, Marwick, Mitchell & Co., Autumn 1978), pp. 10–13. In a more recent survey, U.K. companies remain stubbornly backward-looking. Just 5 percent of FTSE 100 companies address the future of the business in their discussion and analysis. See PricewaterhouseCoopers, "Guide to Forward-looking Information: Don't Fear the Future" (2006).

Questions of Liability

What happens if a company does not meet its forecasts? Can the company and the auditor be sued? If a company, for example, projects an earnings increase of 15 percent and achieves only 5 percent, should shareholders be permitted to have some judicial recourse against the company?

One court case involving **Monsanto Chemical Corporation** (USA) set a precedent. Monsanto predicted that sales would increase 8 to 9 percent and that earnings would rise 4 to 5 percent. In the last part of the year, the demand for Monsanto's products dropped as a result of a business turndown. Instead of increasing, the company's earnings declined. Investors sued the company because the projected earnings figure was erroneous, but a judge dismissed the suit because the forecasts were the best estimates of qualified people whose intents were honest.

As indicated earlier, safe harbor rules are intended to protect companies that provide good-faith projections. However, much concern exists as to how market regulators and the courts will interpret such terms as "good faith" and "reasonable assumptions" when erroneous forecasts mislead users of this information.

Internet Financial Reporting

Most companies now use the power and reach of the Internet to provide more useful information to financial statement readers. All large companies have Internet sites, and a large proportion of companies' websites contain links to their financial statements and other disclosures. The popularity of such reporting is not surprising, as companies can reduce the costs of printing and disseminating paper reports with the use of Internet reporting.

Does Internet financial reporting improve the usefulness of a company's financial reports? Yes, in several ways. First, dissemination of reports via the Internet allows firms **to communicate more easily and quickly with users** than do traditional paper reports. In addition, **Internet reporting allows users to take advantage of tools** such as search engines and hyperlinks to quickly find information about the firm and, sometimes, to download the information for analysis, perhaps in computer spreadsheets. Finally, **Internet reporting can help make financial reports more relevant** by allowing companies to report expanded and more timely disaggregated data than is possible through paper-based reporting. For example, some companies voluntarily report both weekly sales and segment operating data on their websites.

Given the widespread use of the Internet, it is not surprising that organizations are developing new technologies and standards to further enable Internet financial reporting. An example is the increasing use of Extensible Business Reporting Language (**XBRL**), a computer language adapted from the code of the Internet. It "tags" accounting data to correspond to financial reporting items that are reported in the statement of financial position, income statement, the cash flow statement, and even the notes to the financial statements. Once tagged, any company's XBRL data can be easily processed using spreadsheets and other computer programs.

In fact, XBRL is a global language with common tags across countries. To support the use of XBRL by companies reporting under IFRS, the IASB has developed the IFRS taxonomy, a specific set of tags that support financial reporting using XBRL under IFRS guidance. The taxonomy is updated on an annual basis. As more companies prepare their financial reports using XBRL, users will be able to easily search a company's reports, extract and analyze data, and perform financial comparisons within industries and across countries.[17]

Fraudulent Financial Reporting

Economic crime is on the rise around the world. A global survey of over 6,000 executives from 54 countries documented the types of economic crimes, as shown in **Illustration 24.20**.[18]

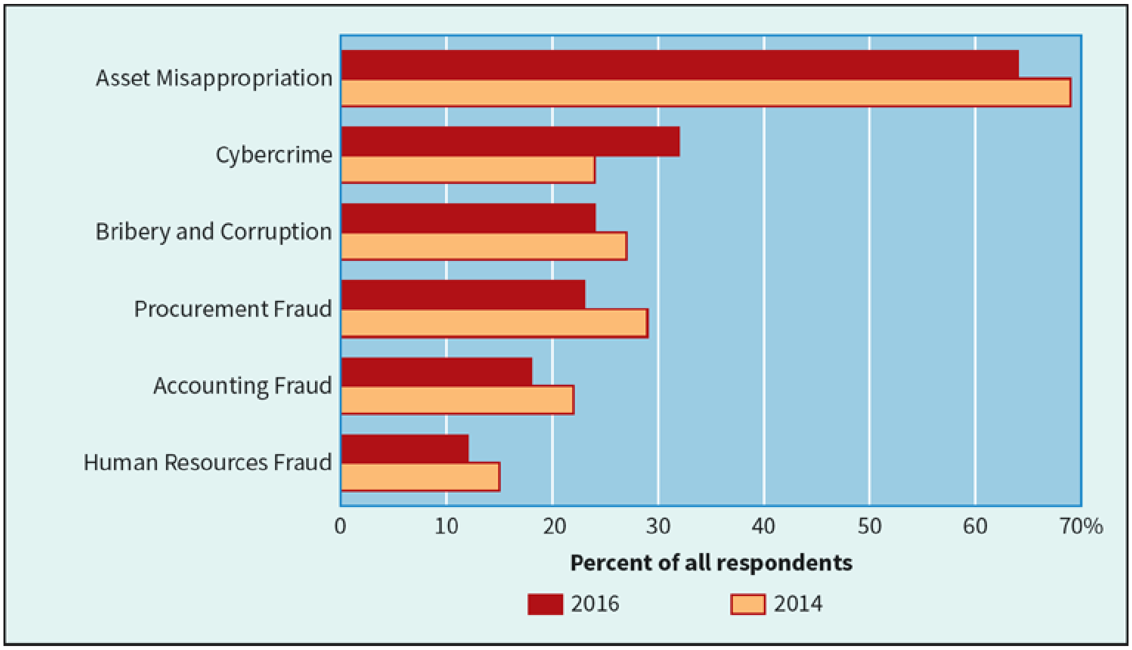


ILLUSTRATION 24.20 **Types of Economic Crime**

As indicated, asset misappropriation, cybercrime, and bribery and corruption top the list. And while the trend has declined slightly, the incidence of economic crime is stubbornly high, with cybercrime jumping 25 percent. Also important and troubling, accounting fraud remains above 15 percent and is ranked fifth in the economic crime hit parade.

Fraudulent financial reporting is defined as "intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements."[19] Fraudulent reporting can involve gross and deliberate distortion of company records (such as inventory count tags), or misapplication of accounting policies (failure to disclose material transactions). The frauds reported in the illustration above, and recent events involving such well-known companies as **Parmalat** (ITA), **Mahindra Satyam** (IND), and **Société Générale** (FRA) indicate that more must be done to address this issue.

Causes of Fraudulent Financial Reporting

Fraudulent financial reporting usually occurs because of conditions in a company's internal or external environment. Influences in the **internal environment** relate to poor internal control systems, management's poor attitude toward ethics, or perhaps a company's liquidity or profitability. Those in the **external environment** may relate to industry conditions, overall business environment, or legal and regulatory considerations.

Motivations for fraudulent financial reporting vary. The desire to obtain a higher share price, avoid default on a loan covenant, or achieve personal gain (e.g., additional compensation, promotion) are common incentives. Situational pressures on the company or an individual manager also may lead to fraudulent financial reporting. Examples of these situational pressures include the following.

- **Sudden decreases in revenue or market share** for a single company or an entire industry.
- **Unrealistic budget pressures** may occur when central headquarters arbitrarily determines profit objectives (particularly for short-term results) budgets and without taking actual conditions into account.
- **Financial pressure resulting from bonus plans** that depend on short-term economic performance. This pressure is particularly acute when the bonus is a significant component of the individual's total compensation.

Opportunities for fraudulent financial reporting are present in circumstances when the fraud is easy to commit and when detection is difficult. Frequently, these opportunities arise from:

1. **The absence of a board of directors or audit committee** that vigilantly oversees the financial reporting process.
2. **Weak or non-existent internal accounting controls.** This situation can occur, for example, when a company's revenue system is overloaded as a result of a rapid expansion of sales, an acquisition of a new division, or the entry into a new, unfamiliar line of business.
3. **Unusual or complex transactions** such as the consolidation of two companies, the divestiture or closing of a specific operation, and the purchase and sale of derivative instruments.
4. **Accounting estimates requiring significant subjective judgment** by company management, such as the allowance for loan losses and the estimated liability for warranty expense.
5. **Ineffective internal audit staffs** resulting from inadequate staff size and severely limited audit scope.

A weak ethical climate in a company contributes to these situations. Opportunities for fraudulent financial reporting also increase dramatically when the accounting policies followed in reporting transactions are non-existent, evolving, or subject to varying interpretations.[20]

As discussed earlier, auditing regulators have issued numerous auditing standards in response to concerns of the accounting profession, the media, and the public.[21] For example, the standard on fraudulent financial reporting "raises the bar" on the performance of financial statement audits by explicitly requiring auditors to assess the risk of material financial misstatement due to fraud.[22]

Criteria for Making Accounting and Reporting Choices

Throughout this text, we have stressed the need to provide information that is useful in predicting the amounts, timing, and uncertainty of future cash flows. To achieve this objective, companies must make judicious choices between alternative accounting concepts, methods, and means of disclosure. You may be surprised by the large number of choices that exist among acceptable alternatives.

You should recognize, however, as indicated in Chapter 1, that accounting is greatly influenced by its environment. It does not exist in a vacuum. Therefore, it is unrealistic to assume that the profession can entirely eliminate alternative presentations of certain transactions and events. Nevertheless, we are hopeful that by adhering to the Conceptual Framework, the profession will be able to focus on the needs of financial statement users and eliminate diversity in practice where appropriate (see **Underlying Concepts**). The IASB's focus on principles-based standards is directed at these very issues. It seeks to develop guidance that will result in accounting and financial reporting that reflects the economic substance of the transactions, not the desired financial result of management. The profession must continue its efforts to develop a sound foundation upon which to build financial standards and practice. As Aristotle said, "The correct beginning is more than half the whole."

Underlying Concepts

The IASB statements on the objective of financial reporting, elements of financial statements, and qualitative characteristics of accounting information are important elements supporting accounting choices that result in high quality financial reporting.

Evolving Issue

Disclosure Overload?

As we discussed in Chapter 1 and throughout the text, IFRS is gaining popularity around the world. The U.S. SEC continues to evaluate whether adoption of IFRS by publicly traded U.S. companies will be mandatory or voluntary. There is some debate on U.S. readiness to make the switch. For example, there are several areas in which the FASB and the IASB must iron out a number of technical accounting issues before they reach a substantially converged set of accounting standards. Here is a list of six important areas yet to be converged.

1. **Error correction.** According to *IAS 8*, it is not always necessary to retrospectively restate financial results when a company corrects errors, especially if the adjustment is impractical or too costly. U.S. GAAP, on the other hand, requires restatements in many error-correction cases.
2. **Death of LIFO.** Last-in, first-out (LIFO) inventory accounting is prohibited under *IAS 2*, so any U.S. company using the method will have to abandon it (and the tax benefits) and move to another methodology. Although LIFO is permitted under U.S. GAAP, the repeal of LIFO for tax purposes is an ongoing debate.
3. **Reversal of impairments.** *IAS 36* permits companies to reverse impairment losses up to the amount of the original impairment when the reason for the charge decreases or no longer exists. However, U.S. GAAP bans reversal.
4. **PP&E valuation.** *IAS 16* allows for the revaluation of property, plant, and equipment, but the entire asset class must be revalued. That means a company can choose to use the revaluation model if the asset class's fair value can be measured reliably. But, it must choose to use one model or the other; both cannot be used at the same time. U.S. GAAP does not allow revaluation.
5. **Component depreciation.** Also under *IAS 16*, companies must recognize and depreciate equipment components separately if the components can be physically separated from the asset and have different useful life spans. In practical terms, that means controllers will have to rely on the operations side of the business to help assess equipment components. U.S. GAAP allows component depreciation, but it is not required.
6. **Development costs.** Based on *IAS 38*, companies are permitted to capitalize development costs as long as they meet six criteria. However, research costs are still expensed. U.S. GAAP requires that all R&D costs be charged to expense when incurred.

Some are already debating what will happen if U.S. companies adopt these new standards. It is almost certain that expanded disclosure will be needed to help users navigate accounting reports upon adoption of IFRS. As one accounting analyst said, "get ready for an avalanche of footnotes." Since using IFRS requires more judgment than using U.S. GAAP, two to three times as many footnotes will be needed to explain the rationales for accounting approaches. So while principles-based standards should promote more comparability, they also require investors to dig into the disclosures in the footnotes. Otherwise, they risk becoming victims of information overload.

Sources: Marie Leone, "GAAP and IFRS: Six Degrees of Separation," CFO.com (June 30, 2010); and T. Shumsky, "As Company Disclosures Balloon, It's Getting Easier to Bury Information," *Wall Street Journal* (February 26, 2016).

APPENDIX 24A
Basic Financial Statement Analysis

LEARNING OBJECTIVE *5

Explain financial statement analysis.

What would be important in studying a company's financial statements? The answer depends on your particular interest—whether you are a creditor, shareholder, potential investor, manager, government agency, or labor leader. For example, **short-term creditors** such as banks are primarily interested in the ability of the firm to pay its currently maturing obligations. In that case, you would examine the current assets and their relation to short-term liabilities to evaluate the short-run solvency of the firm.

Bondholders, on the other hand, look more to long-term indicators, such as the enterprise's capital structure, past and projected earnings, and changes in financial position. **Shareholders**, present or prospective, also are interested in many of the features considered by a long-term creditor. As a shareholder, you would focus on the earnings picture because changes in it greatly affect the market price of your investment. You also would be concerned with the financial position of the company because it affects indirectly the stability of earnings.

The **managers** of a company are concerned about the composition of its capital structure and about the changes and trends in earnings. This financial information has a direct influence on the type, amount, and cost of external financing that the company can obtain. In addition, the company managers find financial information useful on a day-to-day operating basis in such areas as capital budgeting, breakeven analysis, variance analysis and gross margin analysis, and for internal control purposes.

Perspective on Financial Statement Analysis

Readers of financial statements can gather information by examining relationships between items on the statements and identifying trends in these relationships. The relationships are expressed numerically in ratios and percentages, and trends are identified through comparative analysis.

A problem with learning how to analyze statements is that the means may become an end in itself. Analysts could identify and calculate thousands of possible relationships and trends. But knowing only how to calculate ratios and trends without understanding how such information can be used accomplishes little. Therefore, a logical approach to financial statement analysis is necessary, consisting of the following steps.

1. **Know the questions for which you want to find answers.** As indicated earlier, various groups have different types of interest in a company.
2. **Know the questions that particular ratios and comparisons are able to help answer.** These will be discussed in this appendix.
3. **Match 1 and 2 above.** By such a matching, the statement analysis will have a logical direction and purpose.

Several caveats must be mentioned. **Financial statements report on the past.** Thus, analysis of these data is an examination of prior history. When using such information in a decision-making (future-oriented) process, analysts assume that the past is a reasonable basis for predicting the future. This is usually a reasonable approach, but its limitations should be recognized (see Underlying Concepts).

Underlying Concepts

Because financial statements report on the past, they emphasize the *qualitative characteristic of feedback value*. This feedback value is useful because it can be used to better achieve the *qualitative characteristic of predictive value*.

Also, ratio and trend analyses will help identify a company's present strengths and weaknesses. They may serve as "red flags" indicating problem areas. In many cases, however, such analyses will not reveal **why** things are as they are. Finding answers about "why" usually requires an in-depth analysis and an awareness of many factors about a company that are not reported in the financial statements.

Another caveat is that a **single ratio by itself is not likely to be very useful**. For example, analysts may generally view a current ratio of 2 to 1 (current assets are twice current liabilities) as satisfactory. However, if the industry average is 3 to 1, such a conclusion may be invalid. Even given this industry average, you may conclude that the particular company is doing well if you know the previous year's ratio was 1.5 to 1. Consequently, to derive meaning from ratios, analysts need some standard against which to compare them. Such a standard may come from industry averages, past years' amounts, a particular competitor, or planned levels.

Finally, **awareness of the limitations of accounting numbers used in an analysis** is important. We will discuss some of these limitations and their consequences later in this appendix.

Ratio Analysis

In analyzing financial statement data, analysts use various devices to bring out the comparative and relative significance of the financial information presented. These devices include ratio analysis, comparative analysis, percentage analysis, and examination of related data. No one device is more useful than another. Every situation is different, and analysts often obtain the needed answers only upon close examination of the interrelationships among all the data provided. Ratio analysis is the starting point. Ratios can be classified as follows.

Major Types of Ratios

Liquidity Ratios. Measures of the company's short-run ability to pay its maturing obligations.

Activity Ratios. Measures of how effectively the company is using the assets employed.

Profitability Ratios. Measures of the degree of success or failure of a given company or division for a given period of time.

Coverage Ratios. Measures of the degree of protection for long-term creditors and investors.[23]

We have integrated discussions and illustrations about the computation and use of these financial ratios throughout this text. **Illustration 24A.1** summarizes all of the ratios presented in the text and identifies the specific chapters that presented that material.

Summary of Ratios Presented in Earlier Chapters		
Ratio	Formula for Computation	Reference
I. Liquidity		
1. Current ratio	$\dfrac{\text{Current assets}}{\text{Current liabilities}}$	Chapter 13
2. Quick or acid-test ratio	$\dfrac{\text{Cash + Short-term investments + Accounts receivable (net)}}{\text{Current liabilities}}$	Chapter 13
3. Current cash debt coverage	$\dfrac{\text{Net cash provided by operating activities}}{\text{Average current liabilities}}$	Chapter 5
II. Activity		
4. Accounts receivable turnover	$\dfrac{\text{Net sales}}{\text{Average net accounts receivable}}$	Chapter 7
5. Inventory turnover	$\dfrac{\text{Cost of goods sold}}{\text{Average inventory}}$	Chapter 9
6. Asset turnover	$\dfrac{\text{Net sales}}{\text{Average total assets}}$	Chapter 11
III. Profitability		
7. Profit margin on sales	$\dfrac{\text{Net income}}{\text{Net sales}}$	Chapter 11
8. Return on assets	$\dfrac{\text{Net income}}{\text{Average total assets}}$	Chapter 11

Summary of Ratios Presented in Earlier Chapters		
9. Return on ordinary share capital—equity	$\frac{\text{Net income} - \text{Preference dividends}}{\text{Average shareholders' equity—ordinary}}$	Chapter 15
10. Earnings per share	$\frac{\text{Net income} - \text{Preference dividends}}{\text{Weighted-average shares outstanding}}$	Chapter 16
11. Payout ratio	$\frac{\text{Cash dividends}}{\text{Net income}}$	Chapter 15
IV. Coverage		
12. Debt to assets ratio	$\frac{\text{Total liabilities}}{\text{Total assets}}$	Chapter 14
13. Times interest earned	$\frac{\text{Net income} + \text{Interest expense} + \text{Income tax expense}}{\text{Interest expense}}$	Chapter 14
14. Cash debt coverage	$\frac{\text{Net cash provided by operating activities}}{\text{Average total liabilities}}$	Chapter 5
15. Book value per share	$\frac{\text{Shareholders' equity—ordinary}}{\text{Outstanding shares}}$	Chapter 15

ILLUSTRATION 24A.1 Summary of Financial Ratios

Limitations of Ratio Analysis

The reader of financial statements must understand the basic limitations associated with ratio analysis. As analytical tools, ratios are attractive because they are simple and convenient. But too frequently decision-makers base their decisions on only these simple computations. The ratios are only as good as the data upon which they are based and the information with which they are compared.

One important limitation of ratios is that they generally are **based on historical cost, which can lead to distortions in measuring performance**. Inaccurate assessments of the enterprise's financial condition and performance can result from failing to incorporate fair value information.

Also, investors must remember that **where estimated items (such as depreciation and amortization) are significant**, **income ratios lose some of their credibility**. For example, income recognized before the termination of a company's life is an approximation. In analyzing the income statement, users should be aware of the uncertainty surrounding the computation of net income. As one analyst aptly noted, "The physicist has long since conceded that the location of an electron is best expressed by a probability curve. Surely an abstraction like earnings per share is even more subject to the rules of probability and risk."[24]

Probably the greatest limitation of ratio analysis is the **difficult problem of achieving comparability among firms in a given industry**. Achieving comparability requires that the analyst (1) identify basic differences in companies' accounting policies and procedures, and (2) adjust the balances to achieve comparability. Basic differences in accounting usually involve one of the following areas.

1. Inventory valuation (FIFO, average-cost).
2. Depreciation methods, particularly the use of straight-line versus accelerated depreciation.
3. Capitalization versus expensing of certain costs.
4. Investments in ordinary shares carried under the equity method versus fair value.
5. Differing treatments of postretirement benefit costs.
6. Questionable practices of defining discontinued operations, impairments, and unusual items.

The use of these different alternatives can make a significant difference in the ratios computed. For example, at one time **Anheuser-Busch** (now **AB InBev** (BEL)) (USA) noted that if it had used a different inventory method, inventories would have increased approximately $33,000,000. Such an increase would have a substantive impact on the current ratio. Several studies have analyzed the impact of different accounting methods on financial statement analysis. The differences in income that can develop are staggering in some cases. Investors must be aware of the potential pitfalls if they are to be able to make the proper adjustments (see **Underlying Concepts**).[25]

Underlying Concepts

Consistency and comparability are important concepts for financial statement analysis. If the principles and assumptions used to prepare the financial statements are continually changing, accurate assessments of a company's progress become difficult.

Finally, analysts should recognize that a **substantial amount of important information** is not included in a company's financial statements. Events such as industry changes, management changes, competitors' actions, technological developments, government actions, and union activities are often critical to a company's successful operation. These events occur continuously, and information about them must come from careful analysis of financial reports in the media and other sources. Indeed, many argue, in what is known as the **efficient-market hypothesis**, that financial statements contain "no surprises" to those engaged in market activities. They contend that the effect of these events is known in the marketplace—and the price of the company's shares adjusts accordingly—well before the issuance of such reports.

Comparative Analysis

Comparative analysis presents the same information for two or more different dates or periods, so that like items may be compared. Ratio analysis provides only a single snapshot, for one given point or period in time. In a comparative analysis, an investment analyst can concentrate on a given item and determine whether it appears to be growing or diminishing year by year, and the proportion of such change to related items. Generally, companies present comparative financial statements. They typically include two years of statement of financial position information and three years of income statement information.

In addition, many companies include in their annual reports five- or 10-year summaries of pertinent data that permit readers to examine and analyze trends. As indicated in IFRS, "the presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise." **Illustration 24A.2** presents a five-year condensed statement, with additional supporting data, of Anetek Chemical Corporation.

Anetek Chemical Corporation Condensed Comparative Statements (In millions)							
	2022	2021	2020	2019	2018	10 Years Ago 2012	20 Years Ago 2002
Sales and other revenue:							
Net sales	$1,600.0	$1,350.0	$1,309.7	$1,176.2	$1,077.5	$ 636.2	$170.7
Other revenue	75.0	50.0	39.4	34.1	24.6	9.0	3.7
Total	1,675.0	1,400.0	1,349.1	1,210.3	1,102.1	645.2	174.4
Costs and other charges:							
Cost of sales	1,000.0	850.0	827.4	737.6	684.2	386.8	111.0
Depreciation and amortization	150.0	150.0	122.6	115.6	98.7	82.4	14.2
Selling and administrative expenses	225.0	150.0	144.2	133.7	126.7	66.7	10.7
Interest expense	50.0	25.0	28.5	20.7	9.4	8.9	1.8
Income taxes	100.0	75.0	79.5	73.5	68.3	42.4	12.4
Total	1,525.0	1,250.0	1,202.2	1,081.1	987.3	587.2	150.1
Net income for the year	$ 150.0	$ 150.0	$ 146.9	$ 129.2	$ 114.8	$ 58.0	$ 24.3
Other Statistics							
Earnings per share on ordinary shares (in dollars)[a]	$ 5.00	$ 5.00	$ 4.90	$ 3.58	$ 3.11	$ 1.66	$ 1.06
Cash dividends per share on ordinary shares (in dollars)[a]	2.25	2.15	1.95	1.79	1.71	1.11	0.25
Cash dividends declared on ordinary shares	67.5	64.5	58.5	64.6	63.1	38.8	5.7
Share dividend at approximate market value				46.8		27.3	
Taxes (major)	144.5	125.9	116.5	105.6	97.8	59.8	17.0
Wages paid	389.3	325.6	302.1	279.6	263.2	183.2	48.6
Cost of employee benefits	50.8	36.2	32.9	28.7	27.2	18.4	4.4
Number of employees at year end (thousands)	47.4	36.4	35.0	33.8	33.2	26.6	14.6
Additions to property	$306.3	$192.3	$241.5	$248.3	$166.1	$185.0	$49.0

[a]Adjusted for share splits and share dividends.

ILLUSTRATION 24A.2 Condensed Comparative Financial Information

Percentage (Common-Size) Analysis

Analysts also use percentage analysis to help them evaluate and compare companies. **Percentage analysis** consists of reducing a series of related amounts to a series of percentages of a given base. For example, analysts frequently express all items in an income statement as a percentage of sales or sometimes as a percentage of cost of goods sold. They may analyze a statement of financial position on the basis of total assets. Percentage analysis facilitates comparison and is helpful in evaluating the relative size of items or the relative change in items. A conversion of absolute dollar amounts to percentages may also facilitate comparison between companies of different size.

Illustration 24A.3 shows a comparative analysis of the expense section of Anetek Chemical for the last two years.

Anetek Chemical Corporation **Horizontal Comparative Analysis** **(In millions)**				
	2022	2021	Difference	% Change Inc. (Dec.)
Cost of sales	$1,000.0	$850.0	$150.0	17.6%
Depreciation and amortization	150.0	150.0	0	0
Selling and administrative expenses	225.0	150.0	75.0	50.0
Interest expense	50.0	25.0	25.0	100.0
Income taxes	100.0	75.0	25.0	33.3

ILLUSTRATION 24A.3 Horizontal Percentage Analysis

This approach, normally called **horizontal analysis**, indicates the proportionate change over a period of time. It is especially useful in evaluating trends because absolute changes are often deceiving.

Another comparative approach, called **vertical analysis**, is the proportional expression of each financial statement item in a given period to a base figure. For example, Anetek Chemical's income statement using this approach appears in **Illustration 24A.4**.

Anetek Chemical Corporation Income Statement (In millions)		
	Amount	Percentage of Total Revenue
Net sales	$1,600.0	96%
Other revenue	75.0	4
Total revenue	1,675.0	100
Less:		
Cost of sales	1,000.0	60
Depreciation and amortization	150.0	9
Selling and administrative expenses	225.0	13
Interest expense	50.0	3
Income taxes	100.0	6
Total expenses	1,525.0	91
Net income	$ 150.0	9%

ILLUSTRATION 24A.4 **Vertical Percentage Analysis**

Vertical analysis is frequently called **common-size analysis** because it reduces all of the statement items to a "common size." That is, all of the elements within each statement are expressed in percentages of some common number and always add up to 100 percent. Common-size (percentage) analysis reveals the composition of each of the financial statements.

In the analysis of the statement of financial position, common-size analysis answers such questions as: What percentage of the capital structure is represented by equity, current liabilities, or long-term debt? What is the mix of assets (percentage-wise) with which the company has chosen to conduct business? What percentage of current assets is in inventory, receivables, and so forth?

Common-size analysis of the income statement typically relates each item to sales. It is instructive to know what proportion of each sales dollar is absorbed by various costs and expenses incurred by the enterprise.

Analysts may use common-size statements to compare one company's statements from different years, to detect trends not evident from comparing absolute amounts. Also, common- size statements provide intercompany comparisons regardless of size because they recast financial statements into a comparable common-size format.

APPENDIX 24B
First-Time Adoption of IFRS

LEARNING OBJECTIVE *6

Describe first-time adoption of IFRS.

As discussed in Chapter 1, IFRS is growing in acceptance around the world. For example, recent statistics indicate that over 50 percent of the Global Fortune 500 companies use IFRS. And the chair of the IASB predicts that in the near future IFRS adoption will increase, from more than 115 countries to nearly 150 countries.

When countries accept IFRS for use as accepted accounting policies, companies need guidance to ensure that their first IFRS financial statements contain high-quality information. Specifically, *IFRS 1* requires that information in a company's first IFRS statements (1) be transparent, (2) provide a suitable starting point, and (3) have a cost that does not exceed the benefits. **[12]**

The overriding principle in converting from national GAAP (e.g., U.S., Chinese, or Russian) to IFRS (the conversion process) is full retrospective application of all IFRS. Retrospective application—recasting prior financial statements on the basis of IFRS—provides financial statement users with comparable information. However, the IASB recognizes that full retrospective application may be difficult in some situations, particularly when information related to past periods is not readily available. In response, the IASB has established guidelines to ensure that financial statement users have high-quality comparable information while balancing the costs and benefits of providing comparable data.

General Guidelines

The objective of the conversion process is to present a set of IFRS financial statements as if the company had always reported on IFRS. To achieve this objective, a company must:

1. Identify the timing for its first IFRS statements.
2. Prepare an opening statement of financial position at the date of transition to IFRS.
3. Select accounting policies that comply with IFRS and apply these policies retrospectively.
4. Consider whether to apply any optional exemptions and apply mandatory exceptions.
5. Make extensive disclosure to explain the transition to IFRS.

Relevant Dates

Once a company decides to convert to IFRS, it must decide on the transition date and the reporting date. The **transition date** is the beginning of the earliest period for which full comparative IFRS information is presented. The **reporting date** is the closing statement of financial position date for the first IFRS financial statements.

To illustrate, assume that FirstChoice Company plans to provide its first IFRS statements for the year ended December 31, 2023. FirstChoice decides to present comparative information for one year only. Therefore, its date of transition to IFRS is January 1, 2022, and its reporting date is December 31, 2023. The timeline for first-time adoption is presented in **Illustration 24B.1**.

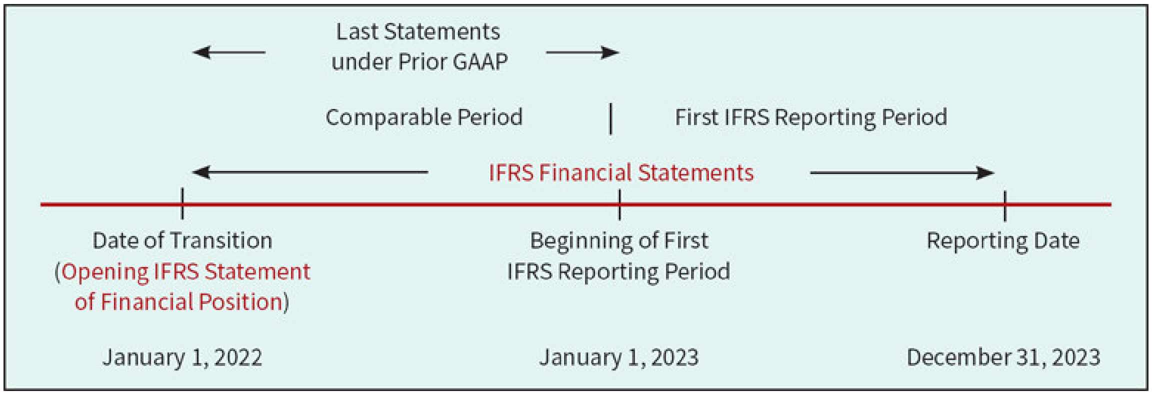


ILLUSTRATION 24B.1 First-Time Adoption Timeline

Illustration 24B.1 shows the following.

1. The **opening IFRS statement of financial position** for FirstChoice on January 1, 2022, serves as the starting point (date of transition) for the company's accounting under IFRS.
2. The first full IFRS statements are shown for FirstChoice for December 31, 2023. In other words, a minimum of two years of IFRS statements must be presented before a conversion to IFRS occurs. As a result, FirstChoice must prepare at least one year of comparative financial statements (for 2022) using IFRS.
3. FirstChoice presents financial statements in accordance with its national GAAP annually to December 31, 2022.

Following this conversion process, FirstChoice provides users of the financial statements with comparable IFRS statements for 2022 and 2023.

Implementation Steps

Opening IFRS Statement of Financial Position

As indicated, to start the conversion process, companies first prepare an opening IFRS statement of financial position. This process involves the following steps.

1. Include all assets and liabilities that IFRS requires.
2. Exclude any assets and liabilities that IFRS does not permit.
3. Classify all assets, liabilities, and equity in accordance with IFRS.
4. Measure all assets and liabilities according to IFRS. **[13]**

Completing this process requires knowledge of both the prior GAAP used and IFRS (which you have obtained by your study of this text). To illustrate, the following facts for NewWorld SA are presented in **Illustration 24B.2**.

Opening Statement of Financial Position

Facts: NewWorld SA is preparing to adopt IFRS. It is preparing its opening statement of financial position on January 1, 2022. NewWorld identified the following accounting policy differences between IFRS and the national GAAP it currently uses. Under national GAAP, NewWorld:

1. Expenses development costs of €500,000 on a project that had met economic viability.
2. Does not make a provision for a warranty of €100,000 because the concept of a "constructive obligation" was not recognized.
3. Does not capitalize design fees of €150,000 into the cost of machinery that was put into service at the beginning of 2020 even though those costs were necessary to bring the asset to its working condition. The machinery has a 5-year life, no residual value, and NewWorld uses straight-line depreciation.

***Question:* How should NewWorld account for these items in its opening IFRS statement of financial position?**

Solution:

1. IFRS allows the deferral of development costs in this case (see Chapter 12), and NewWorld should capitalize these costs.
2. IFRS requires recognition of a warranty provision (see Chapter 13), so a liability should be recorded.
3. Under IFRS, all costs incurred in bringing an asset to its place and condition for its intended use are capitalized into the cost of the asset.

ILLUSTRATION 24B.2 Policy Changes—Opening Statement of Financial Position

Adjustments as a result of applying IFRS for the first time are generally recorded in retained earnings. NewWorld makes the following entries on January 1, 2022, to adjust the accounts to IFRS treatment.

To capitalize development costs		
Development Costs (or related intangible asset)	500,000	
Retained Earnings		500,000
To recognize warranty liability		
Retained Earnings	100,000	
Warranty Liability		100,000
To recognize cost of machinery		
Equipment	150,000	
Accumulated Depreciation—Equipment		60,000
Retained Earnings		90,000

In each of these situations, NewWorld adjusts retained earnings for the differences between IFRS and national GAAP to ensure that the opening statement of financial position is reported in accordance with IFRS.

After recording these adjustments, NewWorld prepares its opening IFRS statement of financial position. The January 1, 2022, statement of financial position is the starting point (the date of transition). Subsequently, in 2022 and 2023, NewWorld prepares IFRS financial statements internally. At December 31, 2023, it will formally adopt IFRS.[26]

Exemptions from Retrospective Treatment

In some cases, adjustments relating to prior periods cannot be reasonably determined. In other cases, it is "impracticable" to provide comparable information because the cost of generating the information exceeds the benefits. The IASB therefore targeted exemptions from the general retrospective treatment where it appeared appropriate. Two types of exemptions are provided—required and elective.

Required Exemptions

The Board identified a number of areas in which companies are prohibited from retrospective application in first-time adoption of IFRS:

1. Estimates.
2. Hedge accounting.
3. Non-controlling interests.
4. Derecognition of financial assets and financial liabilities.
5. Classification and measurement of financial assets.

These required exemptions are imposed because implementation of retrospective application in these areas generally requires companies to obtain information that may not be readily available. In these cases, companies may have to re-create information about past transactions with the benefit of hindsight. **[15]** For example, retrospective application with respect to non-controlling interests requires information about conditions and estimates made at the time of a business combination—often a difficult task. In addition, this exception provides relief for companies that otherwise might have to determine the allocation of transactions between owners and non-controlling interests in periods prior to the transition period.

Elective Exemptions

In addition to the required exemptions for retrospective treatment, the **IASB identified specific additional areas in which companies may elect exemption from retrospective treatment.** These exemptions provide companies some relief from full retrospective application. This simplifies the preparation of the first-time IFRS statements. Areas addressed in the text are presented in **Illustration 24B.3**.[27]

Companies may elect an exemption from retrospective application for one or more of the following areas.

a. Share-based payment transactions.
b. Fair value or revaluation as deemed cost.
c. Leases.
d. Employee benefits.
e. Compound financial instruments.
f. Fair value measurement of financial assets or financial liabilities at initial recognition.
g. Decommissioning liabilities included in the cost of property, plant, and equipment.
h. Borrowing costs.

ILLUSTRATION 24B.3 Elective Exemption from Retrospective Treatment

Optional exemption from retrospective treatment is understandable for certain situations. The accounting for the areas identified above generally requires a number of estimates and assumptions at initial recognition and in subsequent accounting. Depending on the accounting under previous GAAP, the information necessary for retrospective application may not be available, or may be obtained only at a high cost. We discuss two examples.[28]

Exemption Example: Compound Securities

As discussed in Chapter 16, IFRS requires splitting the debt and equity components of convertible debt, using the “with and without” approach. The subsequent accounting for the debt element reflects effective-interest amortization on the estimated debt component. However, if the liability component is no longer outstanding at the date of first-time adoption, retrospective application involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accredited on the liability component. The other portion represents the original equity component. Since the company would not have records on the debt once it is no longer outstanding, it would be costly to re-create that information for retrospective application. As a result, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to IFRS.

Exemption Example: Fair Value or Revaluation as Deemed Cost

Companies can elect to measure property, plant, and equipment at fair value at the transition date and use that fair value as their **deemed cost** in accounting for those assets subsequent to the adoption of IFRS. This exemption may also be applied to intangible assets in certain situations. By using the exemption, companies avoid re-creating depreciation records for property, plant, and equipment, which is a costly exercise for many companies. In fact, in providing this exemption, the IASB noted that reconstructed cost data might be less relevant to users, and less reliable, than current fair value data. The Board therefore concluded that it would allow companies to use fair value as deemed cost. A company that applies the fair value as deemed cost exemption is not required to revalue the assets subsequent to first-time adoption. **[18]**[29]

Presentation and Disclosure

Upon first-time adoption of IFRS, a company must present at least one year of comparative information under IFRS. **[19]** To comply with *IAS 1*, an entity's first IFRS financial statements shall include at least three statements of financial position, two statements of comprehensive income, two separate income statements (if presented), two statements of cash flows, and two statements of changes in equity and related notes, including comparative information. Companies must explain how the transition from previous GAAP to IFRS affected its reported financial position, financial performance, and cash flows.

A company's first IFRS financial statements shall include reconciliations of:

- Its equity reported in accordance with previous GAAP to its equity in accordance with IFRS at the transition date.
- Its total comprehensive income in accordance with IFRS to total comprehensive income in accordance with previous GAAP for the same period. The reconciliation should be prepared for the latest period in the company's most recent annual financial statements under the previous GAAP. **[20]**

Further, if a statement of cash flows was presented under the company's previous GAAP, any material adjustments should be explained. For example, Jones plc first adopted IFRS in 2023, with a date of transition to IFRS of January 1, 2022. Its last financial statements in accordance with previous GAAP were for the year ended December 31, 2022. An example of Jones plc's reconciling items and their effects on equity for first-time adoption is provided in **Illustration 24B.4** for the non-current assets section of the statement of financial position.

Through this disclosure, statement users are able to evaluate the impact of the adoption of IFRS on the statement of financial position. In practice, it may be helpful to include cross-references to accounting policies and supporting analyses that give further explanation of the adjustments shown in the reconciliations.

Jones plc
(amounts in thousands)

First-time adoption effects on equity at January 1, 2022 (date of transition to IFRS)

Note		Previous GAAP	Effect of Transition to IFRS on Equity	IFRS
1	Property, plant, and equipment	£ 8,299	£100	£ 8,399
2	Goodwill	1,220	150	1,370
2	Intangible assets	208	(150)	58
3	Financial assets	3,471	420	3,891
	Total non-current assets	£13,198	£520	£13,718

Notes to the reconciliation at January 1, 2022:

1. Depreciation was influenced by tax requirements in accordance with previous GAAP, but in accordance with IFRS reflects the useful life of the assets. The cumulative adjustment increased the carrying amount of property, plant, and equipment by £100.
2. Intangible assets in accordance with previous GAAP included £150 for items that are transferred to goodwill because they do not qualify for recognition as intangible assets in accordance with IFRS.
3. Financial assets are all classified as non-trading equity investments in accordance with IFRS and are carried at their fair value of £3,891. They were carried at cost of £3,471 in accordance with previous GAAP. The resulting gains of £294 (£420, less related deferred tax of £126) are included in the accumulated other comprehensive income.

ILLUSTRATION 24B.4 Reconciling Items for Equity

Reconciling items for total comprehensive income for Jones with respect to the gross profit section of the income statement are presented in **Illustration 24B.5**.

Jones plc
(amounts in thousands)

Note		Previous GAAP	Effect of Transition to IFRS	IFRS
1, 2, 3	Revenue	£20,910	£ 0	£20,910
	Cost of sales	(15,283)	(97)	(15,380)
	Gross profit	£ 5,627	£(97)	£ 5,530

Notes to the reconciliation of total comprehensive income for 2022:

1. A pension liability is recognized in accordance with IFRS but was not recognized in accordance with previous GAAP. The pension liability increased by £130 during 2022, which caused increases in cost of sales (£50), distribution costs (£30), and administrative expenses (£50).
2. Cost of sales is higher by £47 in accordance with IFRS because inventories include fixed and variable production overhead in accordance with IFRS but not in accordance with previous GAAP.
3. Depreciation was influenced by tax requirements in accordance with previous GAAP but reflects the useful life of the assets in accordance with IFRS. The effect on the profit for 2022 was not material.

Explanation of material adjustments to the statement of cash flows for 2022:

Income taxes of £133 paid during 2022 are classified as operating cash flows in accordance with IFRS but were included in a separate category of tax cash flows in accordance with previous GAAP. There are no other material differences between the statement of cash flows presented in accordance with IFRS and the statement of cash flows presented in accordance with previous GAAP.

ILLUSTRATION 24B.5 Reconciling Items for Total Comprehensive Income

Summary

When companies adopt IFRS, they must ensure that financial statement users receive high-quality information in order to compare financial statements prepared under IFRS and previous GAAP. IFRS guidelines are designed to ensure that upon first-time adoption, financial statements are comparable and that the costs and benefits of first-time adoption are effectively managed.

Review and Practice

Key Terms Review

accounting policies

*activity ratios

adjusted subsequent events

adverse opinion

alternative (or management) performance measures

auditor

auditor's report

common costs

*common-size analysis

*comparative analysis

*coverage ratios

*deemed cost

differential disclosure

disclaimer of an opinion

discrete approach

errors

events after the reporting date

financial forecast

financial projection

fraud

fraudulent financial reporting

full disclosure principle

*horizontal analysis

integral approach

interim reports

key audit matters (KAMs)

*liquidity ratios

management approach

management commentary

modified opinion

non-adjusted subsequent events

notes to the financial statements

*opening IFRS statement of financial position

operating segment

*percentage analysis

*profitability ratios

qualified opinion

related-party transactions

*reporting date

safe harbor rule

seasonality

subsequent events

*transition date

unmodified or clean opinion

*vertical analysis

XBRL

Learning Objectives Review

1 Describe the full disclosure principle and how it is implemented.

The full disclosure principle calls for financial reporting of any financial facts significant enough to influence the judgment of an informed reader. Implementing the full disclosure principle is difficult because the cost can be substantial and the benefits difficult to assess. Disclosure requirements have increased because of (1) the growing complexity of the business environment, (2) the necessity for timely information, and (3) the use of accounting as a control and monitoring device. **Notes in financial statement preparation:** Notes are the accountant's means of amplifying or explaining the items presented in the main body of the statements. Notes can explain in qualitative terms information pertinent to specific financial statement items and can provide supplementary data of a quantitative nature. Common note disclosures include such items as accounting policies; inventories; property, plant, and equipment; creditor claims; contingencies and commitments; and subsequent events.

2 Discuss the disclosure requirements for related-party transactions, subsequent events, major business segments, and interim reporting.

In **related-party transactions**, one party has the ability to significantly influence the actions of the other. As a result, IFRS requires disclosure of the relationship, a description of the transactions including amounts, provisions for doubtful debts, and expenses recognized. For **events after the reporting date**, a company should disclose any transactions that materially affect its financial position or operating situation. Finally, aggregated figures hide important information about the composition of these consolidated figures. There is no way to tell from the consolidated data the extent to which the differing product lines contribute to the company's profitability, risk, and growth potential. As a result, the profession requires **segment information**, with segments identified based on the management approach.

Interim reporting. Interim reports cover periods of less than one year. Two viewpoints exist regarding interim reports. The discrete approach holds that each interim period should be treated as a separate accounting period. The integral approach holds that the interim report is an integral part of the annual report and that deferrals and accruals should take into consideration what will happen for the entire year. IFRS requires use of the discrete approach.

Companies should use the same accounting policies for interim reports that they use for annual reports. A number of unique reporting problems develop related to the following items: (1) income taxes and (2) seasonality.

3 Identify the major disclosures in the auditor's report and management's responsibilities for the financial statements.

The auditor expresses an unmodified or clean opinion if he or she is satisfied that the financial statements present the financial position, results of operations, and cash flows fairly in accordance with IFRS. A qualified opinion contains an exception to the standard opinion; ordinarily, the exception is not of sufficient magnitude to invalidate the statements as a whole.

An adverse opinion is required when the exceptions to fair presentation are so material that a qualified opinion is not justified. A disclaimer of an opinion is appropriate when the auditor has so little information on the financial statements that no opinion can be expressed.

Management commentary complements information reported in the financial statements. This commentary frequently discusses financial aspects of an enterprise's business, such as liquidity, capital resources, results of operations, important risks, and sustainability. Management's responsibility for the financial statements is often indicated in a letter to shareholders in the annual report.

4 Describe other reporting issues related to implementation of the full disclosure principle.

Companies are permitted (not required) to include profit forecasts in their reports. To encourage management to disclose such information, market regulators have issued a safe harbor rule. The rule provides protection to a company that presents an erroneous forecast, as long as it prepared the projection on a reasonable basis and disclosed it in good faith. However, the safe harbor rule has not worked well in practice.

Fraudulent financial reporting is intentional or reckless conduct, whether through act or omission, that results in materially misleading financial statements. Fraudulent financial reporting usually occurs because of poor internal control, management's lax attitude toward ethics, and weak performance.

*5 Explain financial statement analysis.

Basic **financial statement analysis** involves examining relationships between items on the statements (ratio and percentage analysis) and identifying trends in these relationships (comparative analysis). Analysis is used to predict the future, but ratio analysis is limited because the data are from the past. Also, ratio analysis identifies present strengths and weaknesses of a company, but it may not reveal *why* they are as they are. Although single ratios are helpful, they are not conclusive. For maximum usefulness, analysts must compare them with industry averages, past years, planned amounts, and the like.

Ratios are classified as liquidity ratios, activity ratios, profitability ratios, and coverage ratios. (1) *Liquidity ratio analysis* measures the short-run ability of a company to pay its currently maturing obligations. (2) *Activity ratio analysis* measures how effectively a company is using its assets. (3) *Profitability ratio analysis* measures the degree of success or failure of a company to generate revenues adequate to cover its costs of operation and provide a return to the owners. (4) *Coverage ratio analysis* measures the degree of protection afforded long-term creditors and investors.

Limitations of ratio analysis. Ratios are based on historical cost, which can lead to distortions in measuring performance. Also, where estimated items are significant, ratios lose some of their credibility. In addition, comparability problems exist because companies use different accounting policies and procedures. Finally, analysts and other users must recognize that a substantial amount of important information is not included in a company's financial statements.

Comparative analysis. Companies present comparative data, which generally includes two years of statement of financial position information and three years of income statement information. In addition, many companies include in their annual reports five- to 10-year summaries of pertinent data that permit the reader to analyze trends.

Percentage analysis. Percentage analysis consists of reducing a series of related amounts to a series of percentages of a given base. Analysts use two approaches. *Horizontal analysis* indicates the proportionate change in financial statement items over a period of time; such analysis is most helpful in evaluating trends. *Vertical analysis* (common-size analysis) is a proportional expression of each item on the financial statements in a given period to a base amount. It analyzes the composition of each of the financial statements from different years (a) to detect trends not evident from the comparison of absolute amounts and (b) to make intercompany comparisons of different-sized enterprises.

*6 Describe first-time adoption of IFRS.

Upon first-time adoption of IFRS, a company must prepare and present an opening IFRS statement of financial position at the date of transition to IFRS. This is the starting point for its accounting in accordance with IFRS. The general rule for first-time adoption of IFRS is retrospective application. That is, a company shall recast prior financial statements on the basis of IFRS, and use the same accounting policies in its opening IFRS statement of financial position, and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the end of its first IFRS reporting period. Companies provide at least one year of comparative statements prepared in accordance with IFRS.

The opening IFRS statement of financial position. Companies must first prepare the opening IFRS statement of financial position by (1) including all assets and liabilities that IFRS requires; (2) excluding any assets and liabilities that IFRS does not permit; (3) classifying all assets, liabilities, and equity in accordance with IFRS; and (4) measuring all assets and liabilities according to IFRS. Companies must make entries through retrospective application. After recording these adjustments, an opening IFRS statement of financial position is prepared, which will reflect application of the same policies that will be applied in the first IFRS financial statements.

Exemptions to retrospective application in first-time adoption of IFRS. Given the range of changes that might be required for first-time adoption, the IASB considered the cost-benefit of retrospective application and developed targeted exemptions from retrospective treatment, when the amount of the adjustment relating to prior periods cannot be reasonably determined and when it is "impracticable" to provide comparable information. These exemptions are classified as required (in which a company is prohibited from retrospective application) and optional.

Presentation and disclosure requirements. Upon first-time adoption of IFRS, a company presents at least one year of comparative information under IFRS. A company's first IFRS financial statements shall include at least three statements of financial position, two statements of comprehensive income, two separate income statements (if presented), two statements of cash flows, and two statements of changes in equity and related notes, including comparative information. Companies also must explain how the transition from previous GAAP to IFRS affected its reported financial position, financial performance, and cash flows. A company's first IFRS financial statements shall include reconciliations of its equity and total comprehensive income in accordance with previous GAAP to its equity and comprehensive income in accordance with IFRS.

Enhanced Review and Practice

Go online for multiple-choice questions with solutions, review exercises with solutions, and a full glossary of all key terms.

Practice Problem

Konetzke AG, a publicly traded company, is preparing the financial data which it will issue to its shareholders for the fiscal year ending December 31, 2022. Your job as a member of the accounting team is to help determine the appropriate disclosures and any other potential year-end adjustments. You have collected the following information.

1. Konetzke is involved in four separate industries. The following information is available for each of the four industries. Konetzke wonders which segments are reportable, under IFRS.

Operating Segment	Total Revenue	Operating Profit (Loss)	Identifiable Assets
Badger	€ 60,000	€15,000	€167,000
Spartan	10,000	1,500	83,000
Cornhusker	23,000	(2,000)	21,000
Hawkeye	9,000	1,000	19,000
	€102,000	€15,500	€290,000

2. On February 3, 2023, one of Konetzke's customers declared bankruptcy. At December 31, 2022, this company owed Konetzke €15,000, of which €3,000 was paid in January 2023.
3. On January 18, 2023, one of the three major plants of the client burned down.

4. On January 23, 2023, a strike was called at one of Konetzke's largest plants, which halted 30% of its production. As of today (February 13), the strike has not been settled.
5. On February 1, 2023, the board of directors adopted a resolution accepting the offer of an investment banker to guarantee the marketing of €1,200,000 of preference shares.

Instructions

a. State in each case how the 2022 financial statements would be affected, if at all. Financial statements will be authorized for issuance on February 15, 2023.

b. Moving ahead to the first quarter of 2023, your team has compiled the following summarized revenue and expense data for the first quarter of the year.

Sales revenue	€30,000
Cost of goods sold	18,000
Variable selling expenses	500
Fixed selling expenses	1,500

Included in the fixed selling expenses was the single lump-sum payment of €800 for Internet advertisements for the entire year. Address the following with respect to the first quarter report. (1) Explain whether Konetzke should report its operating results for the quarter as if the quarter were a separate reporting period in and of itself, or as if the quarter were an integral part of the annual reporting period. (2) State how the sales revenue, cost of goods sold, and fixed selling expenses would be reflected in Konetzke's quarterly report prepared for the first quarter of 2023.

Solution

a. 1. Konetzke first conducts the following three tests:

Revenue test: .10 × €102,000 = €10,200. The Badger (€60,000) and Cornhusker (€23,000) segments both meet this test.

Operating profit (loss) test: .10 × (€15,000 + €1,500 + €1,000) = €1,750. The Badger (€15,000) and Cornhusker (€2,000 absolute amount) segments both meet this test.

Identifiable assets test: .10 × €290,000 = €29,000. The Badger (€167,000) and Spartan (€83,000) segments both meet this test.

Thus, Konetzke has three reportable segments for which segment information should be disclosed.

Regarding the subsequent events:

2. The financial statements should be adjusted for the expected loss pertaining to the remaining receivable of €12,000. Such adjustment should reduce accounts receivable to their realizable value as of December 31, 2022.
3. Disclose the fire loss in a footnote to the statement of financial position and refer to it in connection with the income statement, since earnings power is presumably

affected.

4. Strikes are considered general knowledge and therefore disclosure is not required. Many auditors, however, would encourage disclosure in all cases.
5. Report the action of the new share issue in a footnote to the statement of financial position.

b. 1. The company should report its quarterly results as if each interim period is discrete.

2. The company's revenue and expenses would be reported as follows on its quarterly report prepared for the first quarter of 2023:

Sales revenue	€30,000
Cost of goods sold	18,000
Variable selling expenses	500
Fixed selling expenses	1,500

Sales revenue and cost of goods sold receive the same treatment as if this were an annual report. Costs and expenses other than product costs should be charged to expense in interim periods as incurred (and not allocated among interim periods.)

If the selling expenses reflect seasonality, one-fourth of Internet advertising could be disclosed as an expense in the first quarter, assuming the advertising is constant throughout the year. These costs can be deferred within the fiscal period if the benefits of the expenditure clearly extend beyond the interim period in which the expenditure is made. A revised quarterly report would appear as follows.

Sales revenue	€30,000
Cost of goods sold	18,000
Variable selling expenses	500
Fixed selling expenses	
Advertising (€800 ÷ 4)	200
Other (€1,500 – €800)	700

Exercises, Problems, Problem Solution Walkthrough Videos, Data Analytics Activities, and many more assessment tools and resources are available for practice in Wiley's online courseware.

Note: All asterisked Questions, Exercises, and Problems relate to material in the appendices to the chapter.

Questions

1. What are the major advantages of notes to the financial statements? What types of items are usually reported in notes?

2. What is the full disclosure principle in accounting? Why has disclosure increased substantially in the last 10 years?

3. The IASB requires a reconciliation between the effective tax rate and the government's statutory rate. Of what benefit is such a disclosure requirement?

4. What type of disclosure or accounting do you believe is necessary for the following items?

a. Because of a general increase in the number of labor disputes and strikes, both within and outside the industry, there is an increased likelihood that a company will suffer a costly strike in the near future.

b. A company reports a loss on a discontinued operation (net of tax) correctly on the income statement. No other mention is made of this item in the annual report.

c. A company expects to recover a substantial amount in connection with a pending refund claim for a prior year's taxes. Although the claim is being contested, counsel for the company has confirmed the client's expectation of recovery.

5. The following information was described in a note of Canon Packing.

"During August, Holland Products AG purchased 311,003 ordinary shares of the Company, which constitutes approximately 35% of the shares outstanding. Holland has since obtained representation on the Board of Directors."

"An affiliate of Holland Products AG acts as a food broker for Canon Packing in the greater Amsterdam marketing area. The commissions for such services after August amounted to approximately €20,000." Why is this information disclosed?

6. What are the major types of subsequent events? Indicate how each of the following "subsequent events" would be reported.

a. Collection of a note written off in a prior period.

b. Issuance of a large preference share offering.

c. Acquisition of a company in a different industry.

d. Destruction of a major plant in a flood.

e. Death of the company's chief executive officer (CEO).

f. Additional wage costs associated with settlement of a 4-week strike.

g. Settlement of an income tax case at considerably more tax than anticipated at year-end.

h. Change in the product mix from consumer goods to industrial goods.

7. What are diversified companies? What accounting problems are related to diversified companies?

8. What quantitative materiality test is applied to determine whether a segment is significant enough to warrant separate disclosure?

9. Identify the segment information that is required to be disclosed by IFRS.

10. What is an operating segment, and when can information about two operating segments be aggregated?

11. The controller for Lafayette AG recently commented, "If I have to disclose our segments individually, the only people who will gain are our competitors and the only people that will lose are our present shareholders." Evaluate this comment.

12. What are interim reports? Why is a complete set of financial statements often not provided with interim data?

13. What are the accounting problems related to the presentation of interim data?

14. Dierdorf SE, a closely held company, has decided to go public. The controller, Ed Floyd, is concerned with presenting interim data when an inventory write-down is recorded. What problems are encountered with inventories when quarterly data are presented?

15. What approaches have been suggested to overcome the seasonality problem related to interim reporting?

16. An article in the financial press entitled "Important Information in Annual Reports This Year" noted that annual reports include a management commentary section. What would this section contain?

17. "The financial statements of a company are management's, not the accountant's." Discuss the implications of this statement.

18. Olga Conrad, a financial writer, noted recently, "There are substantial arguments for including earnings projections in annual reports and the like. The most compelling is that it would give anyone interested something now available to only a relatively select few—like large shareholders, creditors, and attentive bartenders." Identify some arguments against providing earnings projections.

19. The following comment appeared in the financial press: "Inadequate financial disclosure, particularly with respect to how management views the future and its role in the marketplace, has always been a stone in the shoe. After all, if you don't know how a company views the future, how can you judge the worth of its corporate strategy?" What are some arguments for reporting earnings forecasts?

20. What is the difference between an auditor's unmodified opinion, or "clean" opinion, and a modified one?

21. Jane Ellerby and Sam Callison are discussing the recent fraud that occurred at LowRental Leasing plc. The fraud involved the improper reporting of revenue to ensure that the company would have income in excess of $1 million. What is fraudulent financial reporting, and how does it differ from an embezzlement of company funds?

***22.** "The significance of financial statement data is not in the amount alone." Discuss the meaning of this statement.

***23.** A close friend of yours, who is a history major and who has not had any college courses or experience in business, is receiving the financial statements from companies in which he has minor investments (acquired for him by his now-deceased father). He asks you what he needs to know to interpret and evaluate the financial statement data that he is receiving. What would you tell him?

***24.** Distinguish between ratio analysis and percentage analysis relative to the interpretation of financial statements. What is the value of these two types of analyses?

***25.** In calculating inventory turnover, why is cost of goods sold used as the numerator? As the inventory turnover increases, what increasing risk does the business assume?

***26.** What is the relationship of the asset turnover to the return on assets?

***27.** Explain the meaning of the following terms: (a) common-size analysis, (b) vertical analysis, (c) horizontal analysis, and (d) percentage analysis.

***28.** Briefly explain the need for a standard on first-time adoption of IFRS.

***29.** How are the date of transition and the date of reporting determined in first-time adoption of IFRS?

***30.** What are the characteristics of high-quality information in a company's first IFRS financial statements?

***31.** What are the steps to be completed in preparing the opening IFRS statement of financial position?

***32.** What is the rationale for exemptions to retrospective application at first-time adoption of IFRS?

***33.** Briefly describe the required exemptions to retrospective application at first-time adoption of IFRS.

***34.** What are elective exemptions to retrospective application at first-time adoption of IFRS?

***35.** Briefly describe the deemed cost exemption to retrospective application at first-time adoption of IFRS.

***36.** If a company elects the deemed cost exemption, must it continue to use revaluation accounting subsequent to first-time adoption? Explain.

***37.** Briefly describe the presentation and disclosure requirements for first-time adoption of IFRS.

Brief Exercises

BE24.1 **(LO 1)** An annual report of Crestwood Industries states, "The company and its subsidiaries have long-term leases expiring on various dates after December 31, 2022. Amounts payable under such commitments, without reduction for related rental income, are expected to average approximately €5,711,000 annually for the next 3 years. Related rental income from certain subleases to others is estimated to average €3,094,000 annually for the next 3 years." What information is provided by this note?

BE24.2 **(LO 1)** An annual report of Barclays plc states, "Net income per share is computed based upon the average number of shares of all classes outstanding. Additional shares of ordinary shares may be issued or delivered in the future on conversion of outstanding convertible debentures, exercise of outstanding employee share options, and for payment of deferred supplemental compensation. Had such additional shares been outstanding, net income per share would have been reduced by 10¢ in the current year and 3¢ in the previous year.... As a result of share transactions by the company during the current year (primarily the purchase of Class A shares from Barclays Foundation), net income per share was increased by 6¢." What information is provided by this note?

BE24.3 **(LO 2)** Morlan SA is preparing its December 31, 2022, financial statements. Two events that occurred between December 31, 2022, and March 10, 2023, when the statements were authorized for issue, are described below.

1. A liability, estimated at €160,000 at December 31, 2022, was settled on February 26, 2023, at €170,000.
2. A flood loss of €80,000 occurred on March 1, 2023.

What effect do these subsequent events have on 2022 net income?

BE24.4 (LO 2) Tina Bailey, an intermediate accounting student, was heard to remark after a class discussion on segment reporting, "All this is very confusing to me. First we are told that there is merit in presenting the consolidated results, and now we are told that it is better to show segmental results. I wish they would make up their minds." Evaluate this comment.

BE24.5 (LO 2) Foley Group has seven operating segments with total revenues as follows (in millions).

Penley	¥600	Cheng	¥225
Konami	650	Takuhi	200
KSC	250	Molina	700
Red Moon	275		

Based only on the revenues test, which operating segments are reportable?

BE24.6 (LO 2) Operating profits (losses) for the seven operating segments of Foley Group are as follows (in millions).

Penley	¥ 90	Cheng	¥ (20)
Konami	(40)	Takuhi	34
KSC	25	Molina	150
Red Moon	50		

Based only on the operating profit (loss) test, which industry segments are reportable?

BE24.7 (LO 2) Identifiable assets for the seven industry segments of Foley Group are as follows (in millions).

Penley	¥500	Cheng	¥200
Konami	550	Takuhi	150
KSC	250	Molina	475
Red Moon	400		

Based only on the identifiable assets test, which industry segments are reportable?

***BE24.8 (LO 5)** Answer each of the questions in the following unrelated situations.

a. The current ratio of a company is 5:1 and its acid-test ratio is 1:1. If the inventories and prepaid items amount to $500,000, what is the amount of current liabilities?

b. A company had an average inventory last year of $200,000 and its inventory turnover was 5 times. If sales volume and unit cost remain the same this year as last and inventory turnover is 8 times this year, what will average inventory have to be during the current year?

c. A company has current assets of $90,000 (of which $40,000 is inventory and prepaid items) and current liabilities of $40,000. What is the current ratio? What is the acid-test ratio? If the company borrows $15,000 cash from a bank on a 120-day loan, what will its current ratio be? What will the acid-test ratio be?

d. A company has current assets of $600,000 and current liabilities of $240,000. The board of directors declares a cash dividend of $180,000. What is the current ratio after the declaration but before payment? What is the current ratio after the payment of the dividend?

***BE24.9 (LO 5)** Heartland plc's budgeted sales and budgeted cost of goods sold for the coming year are £144,000,000 and £99,000,000, respectively. Short-term interest rates are expected to average 10%. If Heartland can increase inventory turnover from its present level of 9 times a year to a level of 12 times per year, compute its expected cost savings for the coming year.

***BE24.10 (LO 6)** Becker Ltd. is planning to adopt IFRS and prepare its first IFRS financial statements at December 31, 2023. What is the date of Becker's opening statement of financial position, assuming one year of comparative information? What periods will be covered in Becker's first IFRS financial statements?

***BE24.11 (LO 6)** Bohmann Company is preparing its opening IFRS statement of financial position on January 1, 2022. Under its previous GAAP, Bohmann had capitalized all development costs of $50,000. Under IFRS, only $10,000 of the costs related to a patent were incurred after the project met economic viability thresholds. Prepare the entry (if any) needed to record this adjustment at the date of transition.

***BE24.12 (LO 6)** Stengel plc is preparing its opening IFRS statement of financial position on January 1, 2022. Under its previous GAAP, Stengel used the LIFO inventory method. Under LIFO, its inventory is reported at £250,000; under FIFO, which Stengel will use upon adoption of IFRS, the inventory is valued at £265,000. Prepare the entry (if any) needed to record this adjustment at the date of issuance.

***BE24.13 (LO 6)** Latta Inc. is preparing its opening IFRS statement of financial position on January 1, 2022. Under its previous GAAP, Latta had deferred certain advertising costs amounting to $37,000. Prepare the entry (if any) needed to record this adjustment at the date of issuance.

***BE24.14 (LO 6)** Smitz Spa is preparing its opening IFRS statement of financial position on January 1, 2022. Under its previous GAAP, Smitz did not record a provision for litigation in the amount of €85,000 that would be recognized under IFRS. Prepare the entry (if any) needed to record this adjustment at the date of issuance.

***BE24.15 (LO 6)** Porter Company is evaluating the following assets to determine whether it can use fair value as deemed cost in a first-time adoption of IFRS.

1. Biological assets related to agricultural activity for which there is *no* active market.
2. Intangible assets for which there is *no* active market.
3. Any individual item of property, plant, and equipment.
4. Financial assets that are *not* held for trading.

For each asset type, indicate if the deemed cost exemption can be used.

Exercises

E24.1 (LO 2) (Subsequent Events) Keystone Corporation issued its financial statements for the year ended December 31, 2022, on March 10, 2023. The following events took place before the statements were authorized for issue early in 2023.

a. On January 10, 10,000 ordinary shares of $5 par value were issued at $66 per share.

b. On March 1, Keystone determined after negotiations with the taxing authorities that income taxes payable for 2022 should be $1,320,000. At December 31, 2022, income taxes payable were recorded at $1,100,000.

Instructions

Discuss how the preceding subsequent events should be reflected in the 2022 financial statements.

E24.2 (LO 2) (Subsequent Events) Consider the following subsequent events.

_____	1. Settlement of a tax case at a cost considerably in excess of the amount expected at year-end.
_____	2. Introduction of a new product line.
_____	3. Loss of assembly plant due to fire.
_____	4. Sale of a significant portion of the company's assets.
_____	5. Retirement of the company president.
_____	6. Issuance of a significant number of ordinary shares.
_____	7. Loss of a significant customer.
_____	8. Prolonged employee strike.
_____	9. Material loss on a year-end receivable because of a customer's bankruptcy.
_____	10. Hiring of a new president.
_____	

	11. Settlement of prior year's litigation against the company.
_____	12. Merger with another company of comparable size.

Instructions

For each event, indicate whether a company should (a) adjust the financial statements, (b) disclose in notes to the financial statements, or (c) neither adjust nor disclose.

E24.3 (LO 2) (Segment Reporting) LaGreca SpA is involved in four separate industries. The following information is available for each of the four segments.

Operating Segment	Total Revenue	Operating Profit (Loss)	Identifiable Assets
W	€ 60,000	€15,000	€167,000
X	10,000	1,500	83,000
Y	23,000	(2,000)	21,000
Z	9,000	1,000	19,000
	€102,000	€15,500	€290,000

Instructions

Determine which of the operating segments are reportable based on the:

a. Revenue test.

b. Operating profit (loss) test.

c. Identifiable assets test.

***E24.4 (LO 5) (Ratio Computation and Analysis; Liquidity)** As loan analyst for Murray Bank, you have been given the following information.

	Plunkett plc	Herring Ltd.
Assets		
Other assets	£ 500,000	£ 612,000
Current assets		
Inventories	570,000	518,000
Receivables	220,000	302,000
Cash	120,000	320,000
Total current assets	910,000	1,140,000
Total assets	£1,410,000	£1,752,000
Equity and Liabilities		
Share capital and retained earnings	£ 710,000	£ 902,000
Non-current liabilities	400,000	500,000
Current liabilities	300,000	350,000
Total equity and liabilities	£1,410,000	£1,752,000

Annual sales	£ 930,000	£1,500,000
Rate of gross profit on sales	30%	40%

Each of these companies has requested a loan of £50,000 for 6 months with no collateral offered. Since your bank has reached its quota for loans of this type, only one of these requests is to be granted.

Instructions

Judging from the information above, which of the two companies would you recommend as the better risk and why? Assume that the ending account balances are representative of the entire year.

*E24.5 (LO 5) **(Analysis of Given Ratios)** Robbins Company is a wholesale distributor of professional equipment and supplies. The company's sales have averaged about $900,000 annually for the 3-year period 2020–2022. The firm's total assets at the end of 2022 amounted to $850,000.

The president of Robbins Company has asked the controller to prepare a report that summarizes the financial aspects of the company's operations for the past 3 years. This report will be presented to the board of directors at its next meeting.

In addition to comparative financial statements, the controller has decided to present a number of relevant financial ratios which can assist in the identification and interpretation of trends. At the request of the controller, the accounting staff has calculated the following ratios for the 3-year period 2020–2022.

	2020	2021	2022
Current ratio	1.80	1.89	1.96
Acid-test (quick) ratio	1.04	0.99	0.87
Accounts receivable turnover	8.75	7.71	6.42
Inventory turnover	4.91	4.32	3.72
Debt to assets ratio	51.0%	46.0%	41.0%
Long-term debt to assets ratio	31.0%	27.0%	24.0%
Sales to fixed assets (fixed asset turnover)	1.58	1.69	1.79
Sales as a percent of 2020 sales	1.00	1.03	1.05
Gross margin percentage	36.0%	35.1%	34.6%
Net income to sales	6.9%	7.0%	7.2%
Return on assets	7.7%	7.7%	7.8%
Return on equity	13.6%	13.1%	12.7%

In preparing the report, the controller has decided first to examine the financial ratios independent of any other data to determine whether the ratios themselves reveal any significant trends over the 3-year period.

Instructions

a. The current ratio is increasing while the acid-test (quick) ratio is decreasing. Using the ratios provided, identify and explain the contributing factor(s) for this apparently divergent trend.

b. In terms of the ratios provided, what conclusion(s) can be drawn regarding the company's use of financial leverage during the 2020–2022 period?

c. Using the ratios provided, what conclusion(s) can be drawn regarding the company's net investment in plant and equipment?

***E24.6 (LO 5) (Ratio Analysis)** Howser Ltd. is a manufacturer of electronic components and accessories with total assets of £20,000,000. Selected financial ratios for Howser and the industry averages for firms of similar size are presented below.

	Howser			2022 Industry Average
	2020	2021	2022	
Current ratio	2.09	2.27	2.51	2.24
Quick ratio	1.15	1.12	1.19	1.22
Inventory turnover	2.40	2.18	2.02	3.50
Net sales to equity	2.75	2.80	2.95	2.85
Net income to equity	0.14	0.15	0.17	0.11
Total liabilities to equity	1.41	1.37	1.44	0.95

Howser is being reviewed by several entities whose interests vary, and the company's financial ratios are a part of the data being considered. Each of the parties listed below must recommend an action based on its evaluation of Howser's financial position.

Citizens National Bank. The bank is processing Howser's application for a new 5-year term note. Citizens National has been Howser's banker for several years but must reevaluate the company's financial position for each major transaction.

Charleston Company. Charleston is a new supplier to Howser and must decide on the appropriate credit terms to extend to the company.

Shannon Financial. A brokerage firm specializing in the shares of electronics firms that are sold over-the-counter, Shannon Financial must decide if it will include Howser in a new fund being established for sale to Shannon Financial's clients.

Working Capital Management Committee. This is a committee of Howser's management personnel chaired by the chief operating officer. The committee is charged with the responsibility of periodically reviewing the company's working capital position, comparing actual data against budgets, and recommending changes in strategy as needed.

Instructions

a. Describe the analytical use of each of the six ratios presented above.

b. For each of the four entities described above, identify two financial ratios, from those ratios presented in Illustration 24A.1, that would be most valuable as a basis for its decision regarding Howser.

c. Discuss what the financial ratios presented in the question reveal about Howser. Support your answer by citing specific ratio levels and trends as well as the interrelationships between these ratios.

***E24.7 (LO 6) (Opening Statement of Financial Position)** Goodman AG is preparing to adopt IFRS. In preparing its opening statement of financial position on January 1, 2022, Goodman identified the following accounting policy differences between IFRS and its previous GAAP.

1. Under its previous GAAP, Goodman classified proposed dividends of €45,000 as a current liability.
2. Goodman had deferred advertising costs of €500,000.

Instructions

a. Prepare the journal entries needed (if any) before preparation of Goodman's opening statement of financial position.

b. Determine the net change in equity from these adjustments.

***E24.8 (LO 6) (Opening Statement of Financial Position, Disclosure)** Lombardo Group is preparing to adopt IFRS. It is preparing its opening statement of financial position on January 1, 2022. Lombardo identified the following accounting policy differences between IFRS and its previous GAAP.

1. Lombardo had not made a provision for a warranty of €75,000 under previous GAAP because the concept of a "constructive obligation" was not recognized.
2. Under previous GAAP, €60,000 paid for certain architect fees was not capitalized into the cost of a building that was put into service at the beginning of 2021, even though those costs were necessary to bring the asset to its working condition. The building has a 40-year life and no residual value, and Lombardo uses straight-line depreciation.

Instructions

a. Prepare the journal entries needed (if any) before preparation of Lombardo's opening statement of financial position.

b. Determine the net change in equity from these adjustments.

c. Briefly describe the disclosures that Lombardo will make related to the adjustments in it first IFRS financial statements.

Problems

P24.1 (LO 2) (Subsequent Events) Your firm has been engaged to examine the financial statements of Almaden AG for the year 2022. The bookkeeper who maintains the financial records has prepared all the unaudited financial statements for the company since its organization on January 2, 2017. The client provides you with the following information.

Almaden AG Statement of Financial Position December 31, 2022	
Assets	**Liabilities**

Almaden AG Statement of Financial Position December 31, 2022			
		Equity	€4,650,600
Other assets	€5,171,400	Non-current liabilities	1,439,500
Current assets	1,881,100	Current liabilities	962,400
	€7,052,500		€7,052,500

Current assets include:	
Cash (restricted in the amount of €300,000 for plant expansion)	€ 571,000
Investments in land	185,000
Accounts receivable less allowance of €30,000	480,000
Inventories (weighted-average)	645,100
	€ 1,881,100
Other assets include:	
Prepaid expenses	€ 62,400
Plant and equipment less accumulated depreciation of €1,430,000	4,130,000
Notes receivable (short-term)	162,300
Goodwill	252,000
Land	564,700
	€ 5,171,400
Current liabilities include:	
Accounts payable	€ 510,000
Notes payable (due 2025)	157,400
Estimated income taxes payable	145,000
Share premium—ordinary	150,000
	€ 962,400
Non-current liabilities include:	
Unearned revenue	€ 489,500
Dividends payable (cash)	200,000
8% bonds payable (due May 1, 2027)	750,000
	€ 1,439,500
Equity includes:	
Retained earnings	€ 2,810,600
Share capital—ordinary, par value €10; authorized 200,000 shares, 184,000 shares issued	1,840,000
	€ 4,650,600

The supplementary information below is also provided.

1. On May 1, 2022, the company issued at par €750,000 of bonds to finance plant expansion. The long-term bond agreement provided for the annual payment of interest every May 1. The existing plant was pledged as security for the loan.
2. The bookkeeper made the following mistakes.
   a. In 2020, the ending inventory was overstated by €183,000. The ending inventories for 2021 and 2022 were correctly computed.
   b. In 2022, accrued wages in the amount of €225,000 were omitted from the statement of financial position, and these expenses were not charged on the income statement.
   c. In 2022, a gain of €175,000 (net of tax) on the sale of certain plant assets was credited directly to retained earnings.
3. A major competitor has introduced a line of products that will compete directly with Almaden's primary line, now being produced in a specially designed new plant. Because of manufacturing innovations, the competitor's line will be of comparable quality but priced 50% below Almaden's line. The competitor announced its new line on January 14, 2023. Almaden indicates that the company will meet the lower prices, which are high enough to cover variable manufacturing and selling expenses, but permit recovery of only a portion of fixed costs.
4. You learned on January 28, 2023, prior to completion of the audit, of heavy damage because of a recent fire in one of Almaden's two plants; the loss will not be reimbursed by insurance. The newspapers described the event in detail.

Instructions

Analyze the preceding information to prepare a corrected statement of financial position for Almaden in accordance with IFRS. Prepare a description of any notes that might need to be prepared. The books are closed, and adjustments to income are to be made through retained earnings.

P24.2 (LO 2) (Segment Reporting) Cineplex Corporation is a diversified company that operates in five different industries: A, B, C, D, and E. The following information relating to each segment is available for 2022.

	A	B	C	D	E
Sales revenue	$40,000	$ 75,000	$580,000	$35,000	$55,000
Cost of goods sold	19,000	50,000	270,000	19,000	30,000
Operating expenses	10,000	40,000	235,000	12,000	18,000
Total expenses	29,000	90,000	505,000	31,000	48,000
Operating profit (loss)	$11,000	$(15,000)	$ 75,000	$ 4,000	$ 7,000
Identifiable assets	$35,000	$ 80,000	$500,000	$65,000	$50,000

Sales of segments B and C included intersegment sales of $20,000 and $100,000, respectively.

Instructions

a. Determine which of the segments are reportable based on the:

1. Revenue test.
2. Operating profit (loss) test.
3. Identifiable assets test.

b. Prepare the necessary disclosures required by IFRS.

***P24.3 (LO 5) Groupwork (Ratio Computations and Additional Analysis)** Bradburn plc was formed 5 years ago through a public subscription of ordinary shares. Daniel Brown, who owns 15% of the ordinary shares, was one of the organizers of Bradburn and is its current president. The company has been successful but is currently experiencing a shortage of funds. On June 10, Daniel Brown approached the Hibernia Bank, asking for a 24-month extension on two £35,000 notes, which are due on June 30, 2022, and September 30, 2022. Another note of £6,000 is due on March 31, 2023, but he expects no difficulty in paying this note on its due date. Brown explained that Bradburn's cash flow problems are due primarily to the company's desire to finance a £300,000 plant expansion over the next 2 fiscal years through internally generated funds.

The commercial loan officer of Hibernia Bank requested financial reports for the last 2 fiscal years. These reports are reproduced below.

Bradburn plc
Statement of Financial Position
March 31

Assets	2022	2021
Plant and equipment (net of depreciation)	£1,449,000	£1,420,500
Inventories (at cost)	105,000	50,000
Accounts receivable (net)	131,800	125,500
Notes receivable	148,000	132,000
Cash	18,200	12,500
Total assets	£1,852,000	£1,740,500
Equity and Liabilities		
Share capital—ordinary (130,000 shares, £10 par)	£1,300,000	£1,300,000
Retained earnings[a]	388,000	282,000
Accrued liabilities	9,000	6,000
Notes payable	76,000	61,500
Accounts payable	79,000	91,000
Total equity and liabilities	£1,852,000	£1,740,500

[a] Cash dividends were paid at the rate of £1 per share in fiscal year 2021 and £2 per share in fiscal year 2022.

Bradburn plc
Income Statement
For The Fiscal Years Ended March 31

	2022	2021

Bradburn plc Income Statement For The Fiscal Years Ended March 31		
Sales revenue	£3,000,000	£2,700,000
Cost of goods sold[a]	1,530,000	1,425,000
Gross margin	1,470,000	1,275,000
Operating expenses	860,000	780,000
Income before income taxes	610,000	495,000
Income taxes (40%)	244,000	198,000
Net income	£ 366,000	£ 297,000

[a]Depreciation charges on the plant and equipment of £100,000 and £102,500 for fiscal years ended March 31, 2021 and 2022, respectively, are included in cost of goods sold.

Instructions

a. Compute the following items for Bradburn plc.
   1. Current ratio for fiscal years 2021 and 2022.
   2. Acid-test (quick) ratio for fiscal years 2021 and 2022.
   3. Inventory turnover for fiscal year 2022.
   4. Return on assets for fiscal years 2021 and 2022. (Assume total assets were £1,688,500 at 3/31/20.)
   5. Percentage change in sales, cost of goods sold, gross margin, and net income after taxes from fiscal year 2021 to 2022.

b. Identify and explain what other financial reports and/or financial analyses might be helpful to the commercial loan officer of Hibernia Bank in evaluating Daniel Brown's request for a time extension on Bradburn's notes.

c. Assume that the percentage changes experienced in fiscal year 2022 as compared with fiscal year 2021 for sales, cost of goods sold, and expenses will be repeated in each of the next 2 years and that the dividend amount will be held constant at the 2022 rate. Is Bradburn's desire to finance the plant expansion from internally generated funds realistic? Discuss.

d. Should Hibernia Bank grant the extension on Bradburn's notes considering Daniel Brown's statement about financing the plant expansion through internally generated funds? Discuss.

***P24.4 (LO 5) (Horizontal and Vertical Analysis)** Presented below are comparative statements of financial position for Ozturk Ltd.

Ozturk Ltd. Comparative Statements of Financial Position As of December 31, 2022 and 2021		
	December 31	
	2022	2021

Ozturk Ltd. Comparative Statements of Financial Position As of December 31, 2022 and 2021		
Assets		
Fixed assets	₺2,585,000	₺1,950,000
Accumulated depreciation	(1,000,000)	(750,000)
Prepaid expenses	25,000	25,000
Inventories	1,060,000	980,000
Accounts receivable (net)	220,000	155,000
Short-term investments	270,000	150,000
Cash	180,000	275,000
	₺3,340,000	₺2,785,000
Equity and Liabilities		
Share capital—ordinary	₺2,100,000	₺1,770,000
Retained earnings	570,000	550,000
Bonds payable	450,000	190,000
Accrued expenses	170,000	200,000
Accounts payable	50,000	75,000
	₺3,340,000	₺2,785,000

Instructions

(Round to two decimal places.)

a. Prepare a comparative statement of financial position of Ozturk Ltd. showing each item's percentage of the total assets or total equity and liabilities.

b. Prepare a comparative statement of financial position of Ozturk Ltd. showing the Turkish lira change and the percent change for each item.

c. Of what value is the additional information provided in part (a)?

d. Of what value is the additional information provided in part (b)?

***P24.5 (LO 5)** Writing **(Dividend Policy Analysis)** Matheny AG went public 3 years ago. The board of directors will be meeting shortly after the end of the year to decide on a dividend policy. In the past, growth has been financed primarily through the retention of earnings. No share or cash dividend has ever been declared. Presented below is a brief financial summary of Matheny AG operations (euros in thousands).

	2022	2021	2020	2019	2018
Sales revenue	€20,000	€16,000	€14,000	€6,000	€4,000
Net income	2,400	1,400	800	700	250
Average total assets	22,000	19,000	11,500	4,200	3,000
Current assets	8,000	6,000	3,000	1,200	1,000

Working capital	3,600	3,200	1,200	500	400
Ordinary shares:					
Number of shares outstanding (in thousands)	2,000	2,000	2,000	20	20
Average market price	€9	€6	€4	—	—

Instructions

a. Suggest factors to be considered by the board of directors in establishing a dividend policy.

b. Compute the return on assets, profit margin on sales, earnings per share, price-earnings ratio, and current ratio for each of the 5 years for Matheny AG.

c. Comment on the appropriateness of declaring a cash dividend of €0.20 per share at this time, using the ratios computed in part (b) as a major factor in your analysis.

Concepts for Analysis

CA24.1 (LO 1) (General Disclosures; Inventories; Property, Plant, and Equipment) Koch Corporation is in the process of preparing its annual financial statements for the fiscal year ended April 30, 2022. The company manufactures plastic, glass, and paper containers for food and drink manufacturers and distributors.

Koch Corporation maintains separate control accounts for its raw materials, work in process, and finished goods inventories for each of the three types of containers. The inventories are valued at the lower-of-cost-or-net realizable value.

The company's property, plant, and equipment are classified in the following major categories: land, office buildings, furniture and fixtures, manufacturing facilities, manufacturing equipment, and leasehold improvements. All fixed assets are carried at cost. The depreciation methods employed depend on the type of asset (its classification) and when it was acquired.

Koch Corporation plans to present the inventory and fixed asset amounts in its April 30, 2022, statement of financial position as shown below.

Inventories	$4,814,200
Property, plant, and equipment (net of depreciation)	6,310,000

Instructions

What information regarding inventories and property, plant, and equipment must be disclosed by Koch Corporation in the audited financial statements issued to shareholders, either in the body or the notes, for the 2021–2022 fiscal year?

CA24.2 (LO 1, 2) (Disclosures Required in Various Situations) Ace SA produces electronic components for sale to manufacturers of radios, television sets, and digital sound systems. In connection with her examination of Ace's financial statements for the year ended December 31, 2022, Gloria Rodd completed field work 2 weeks ago. Ms. Rodd now is evaluating the significance of the following items prior to preparing her auditor's report. Except as noted, none of these items have been disclosed in the financial statements or notes.

Item 1: A 10-year loan agreement, which the company entered into 3 years ago, provides that dividend payments may not exceed net income earned after taxes subsequent to the date of the agreement. The balance of retained earnings at the date of the loan agreement was €420,000. From that date through December 31, 2022, net income after taxes has totaled €570,000 and cash dividends have totaled €320,000. On the basis of these data, the staff auditor assigned to this review concluded that there was no retained earnings restriction at December 31, 2022.

Item 2: Recently, Ace interrupted its policy of paying cash dividends quarterly to its shareholders. Dividends were paid regularly through 2021, discontinued for all of 2022 to finance purchase of equipment for the company's new plant, and resumed in the first quarter of 2023. In the annual report, dividend policy is to be discussed in the president's letter to shareholders.

Item 3: A major electronics firm has introduced a line of products that will compete directly with Ace's primary line, now being produced in the specially designed new plant. Because of manufacturing innovations, the competitor's line will be of comparable quality but priced 50% below Ace's line. The competitor announced its new line during the week following completion of field work (but before the financial statement authorization date). Ms. Rodd read the announcement in the newspaper and discussed the situation by telephone with Ace executives. Ace will meet the lower prices that are high enough to cover variable manufacturing and selling expenses but will permit recovery of only a portion of fixed costs.

Item 4: The company's new manufacturing plant building, which cost €2,400,000 and has an estimated life of 25 years, is leased from Wichita National Bank at an annual rental of €600,000. The company is obligated to pay property taxes, insurance, and maintenance. At the conclusion of its 10-year non-cancelable lease, the company has the option of purchasing the property for €1. In Ace's income statement, the rental payment is reported on a separate line.

Instructions

For each of the items, discuss any additional disclosures in the financial statements and notes that the auditor should recommend to her client. (The cumulative effect of the four items should not be considered.)

CA24.3 (LO 1) (Disclosures, Conditional and Contingent Liabilities) Presented below are three independent situations.

Situation 1: A company offers a one-year warranty for the product that it manufactures. A history of warranty claims has been compiled, and the probable amounts of claims related to sales for a given period can be determined.

Situation 2: Subsequent to the date of a set of financial statements but prior to the authorization of issuance of the financial statements, a company enters into a contract that will probably result in a significant loss to the company. The amount of the loss can be reasonably estimated.

Situation 3: A company has adopted a policy of recording self-insurance for any possible losses resulting from injury to others by the company's vehicles. The premium for an insurance policy for the same risk from an independent insurance company would have an annual cost of £4,000. During the period covered by the financial statements, there were no accidents involving the company's vehicles that resulted in injury to others.

Instructions

Discuss the accrual or type of disclosure necessary (if any) and the reason(s) why such disclosure is appropriate for each of the three independent sets of facts above.

CA24.4 (LO 2) Groupwork **(Subsequent Events)** At December 31, 2021, Coburn plc has assets of £10,000,000, liabilities of £6,000,000, share capital of £2,000,000 (representing 2,000,000 ordinary shares at £1 par), and retained earnings of £2,000,000. Net sales for the year 2021 were £18,000,000, and net income was £800,000. You are making a review of subsequent events on February 13, 2022, and you find the following.

1. On February 3, 2022, one of Coburn's customers declared bankruptcy. At December 31, 2021, this company owed Coburn £300,000, of which £60,000 was paid in January 2022.
2. On January 18, 2022, one of the three major plants of the client burned.
3. On January 23, 2022, a strike was called at one of Coburn's largest plants, which halted 30% of its production. As of today (February 13), the strike has not been settled.
4. A major electronics enterprise has introduced a line of products that would compete directly with Coburn's primary line, now being produced in a specially designed new plant. Because of manufacturing innovations, the competitor has been able to achieve quality similar to that of Coburn's products but at a price 50% lower. Coburn officials say they will meet the lower prices, which are high enough to cover variable manufacturing and selling costs but which permit recovery of only a portion of fixed costs.
5. Merchandise traded in the open market was recorded in the company's records at £1.40 per unit on December 31, 2021. This price prevailed for 2 weeks, after release of an official market report that predicted vastly increased supplies; however, no purchases were made at £1.40. The price throughout the preceding year had been about £2, which had been the level experienced over several years. On January 18, 2022, the price returned to £2, after public disclosure of an error in the official calculations of the prior December correction of which destroyed the expectations of excessive supplies. Inventory at December 31, 2021, was on a lower-of-cost-or-net realizable value basis.
6. On February 1, 2022, the board of directors adopted a resolution accepting the offer of an investment banker to guarantee the marketing of £1,200,000 of preference shares.

Instructions

State in each case how the 2021 financial statements would be affected, if at all.

CA24.5 (LO 2) Writing **(Segment Reporting)** You are compiling the consolidated financial statements for Winsor Corporation International (WCI). The corporation's accountant, Anthony Reese, has provided you with the following segment information.

Note 7: Major Segments of Business

WCI conducts funeral service and cemetery operations in the United States and Canada. Substantially all revenues of WCI's major segments of business are from unaffiliated customers. Segment information for fiscal 2022, 2021, and 2020 follows (amounts in thousands).

	Funeral	Floral	Cemetery	Real Estate	Dried Whey	Limousine	Consolidated
Revenues							
2022	$302,000	$10,000	$ 73,000	$ 2,000	$7,000	$12,000	$406,000
2021	245,000	6,000	61,000	4,000	4,000	4,000	324,000
2020	208,000	3,000	42,000	3,000	1,000	3,000	260,000
Operating Income							
2022	74,000	1,500	18,000	(36,000)	500	2,000	60,000
2021	64,000	200	12,000	(28,000)	200	400	48,800
2020	54,000	150	6,000	(21,000)	100	350	39,600
Capital Expenditures							
2022	26,000	1,000	9,000	400	300	1,000	37,700
2021	28,000	2,000	60,000	1,500	100	700	92,300
2020	14,000	25	8,000	600	25	50	22,700
Depreciation and Amortization							
2022	13,000	100	2,400	1,400	100	200	17,200
2021	10,000	50	1,400	700	50	100	12,300
2020	8,000	25	1,000	600	25	50	9,700
Identifiable Assets							
2022	334,000	1,500	162,000	114,000	500	8,000	620,000
2021	322,000	1,000	144,000	52,000	1,000	6,000	526,000
2020	223,000	500	78,000	34,000	500	3,500	339,500

Instructions

Determine which of the segments must be reported separately and which can be combined under the category "Other." Then, write a one-page memo to the company's accountant, Anthony Reese, explaining the following.

a. Which segments must be reported separately and Which segments can be combined.

b. Which criteria you used to determine reportable segments.

c. Which major items must be disclosed for each.

CA24.6 (LO 2) (Interim Reporting) Sino Group, a publicly traded company, is preparing the interim financial data which it will issue to its shareholders at the end of the first quarter of the 2021–2022 fiscal year. Sino's financial accounting department has compiled the following summarized revenue and expense data for the first quarter of the year.

Sales revenue	¥60,000,000
Cost of goods sold	36,000,000

Variable selling expenses	1,000,000
Fixed selling expenses	3,000,000

Included in the fixed selling expenses was the single lump-sum payment of ¥2,000,000 for television advertisements for the entire year.

Instructions

a. Sino Group must issue its quarterly financial statements in accordance with IFRS regarding interim financial reporting.

1. Explain whether Sino should report its operating results for the quarter as if the quarter were a separate reporting period in and of itself, or as if the quarter were an integral part of the annual reporting period.
2. State how the sales revenue, cost of goods sold, and fixed selling expenses would be reflected in Sino Group's quarterly report prepared for the first quarter of the 2021–2022 fiscal year. Briefly justify your presentation.

b. What financial information, as a minimum, must Sino Group disclose to its shareholders in its quarterly reports?

CA24.7 (LO 2) Groupwork (Treatment of Various Interim Reporting Situations) The following are six independent cases on how accounting facts might be reported on an individual company's interim financial reports.

Instructions

For each of these cases, state whether the method proposed for interim reporting would be acceptable under IFRS. Support each answer with a brief explanation.

a. J. D. Long Company takes a physical inventory at year-end for annual financial statement purposes. Inventory and cost of sales reported in the interim quarterly statements are based on estimated gross profit rates because a physical inventory would result in a cessation of operations. Long Company does have reliable perpetual inventory records.

b. Rockford Company is planning to report one-fourth of its pension expense each quarter.

c. Republic Company wrote inventory down to reflect lower-of-cost-or-net realizable value in the first quarter. At year-end, the net realizable value exceeds the original acquisition cost of this inventory. Consequently, management plans to write the inventory back up to its original cost as a year-end adjustment.

d. Gansner Company realized a large gain on the sale of investments at the beginning of the second quarter. The company wants to report one-third of the gain in each of the remaining quarters.

e. Fredonia Company has estimated its annual audit fee. It plans to pro rate this expense equally over all four quarters.

f. LaBrava Company was reasonably certain it would have an employee strike in the third quarter. As a result, it shipped heavily during the second quarter but plans to defer the recognition of the sales in excess of the normal sales volume. The deferred sales will be recognized as sales in the third quarter when the strike is in progress. LaBrava Company management thinks this is more representative of normal second- and third-quarter operations.

CA24.8 (LO 4) Writing **(Financial Forecasts)** An article in *Barron's* noted the following.

"Okay. Last fall, someone with a long memory and an even longer arm reached into that bureau drawer and came out with a moldy cheese sandwich and the equally moldy notion of corporate forecasts. However, the forecast proposal was dusted off, polished up and found quite serviceable. The U.S. SEC, indeed, lost no time in running it up the old flagpole—but no one was very eager to salute. Even after some of the more objectionable features—compulsory corrections and detailed explanations of why the estimates went awry—were peeled off the original proposal.

Seemingly, despite the Commission's smiles and sweet talk, those craven corporations were still afraid that an honest mistake would lead them down the primrose path to consent decrees and class action suits. To lay to rest such qualms, the Commission last week approved a "Safe Harbor" rule that, providing the forecasts were made on a reasonable basis and in good faith, protected corporations from litigation should the projections prove wide of the mark (as only about 99% are apt to do)."

Instructions

a. What are the arguments for preparing profit forecasts?

b. What is the purpose of the "safe harbor" rule?

c. Why are companies concerned about presenting profit forecasts?

CA24.9 (LO 1) Ethics **(Disclosure of Estimates)** Nancy Tercek, the financial vice president, and Margaret Lilly, the controller, of Romine Manufacturing Company are reviewing the financial ratios of the company for the years 2022 and 2023. Tercek notes that the profit margin on sales has increased from 6% to 12%, a hefty gain for the 2-year period. She is in the process of issuing a media release that emphasizes the efficiency of Romine Manufacturing in controlling costs. Margaret Lilly knows that the difference in ratios is due primarily to an earlier company decision to reduce the estimates of warranty and bad debt expense for 2023. Lilly, who is unsure of her supervisor's motives, hesitates to suggest to Tercek that the company's improvement is unrelated to efficiency in controlling costs. To complicate matters, the media release is scheduled in a few days.

Instructions

a. What is the ethical dilemma in this situation, if any?

b. Should Lilly, the controller, remain silent? Give reasons.

c. What stakeholders might be affected by Tercek's media release?

d. Give your opinion on the following statement and cite reasons: "Because Tercek, the vice president, is most directly responsible for the media release, Lilly has no real responsibility in this matter."

CA24.10 (LO 2) Ethics **(Reporting of Subsequent Events)** In June 2022, the board of directors for McElroy Enterprises authorizes the sale of £10,000,000 of company bonds. Jennifer Grayson, treasurer for McElroy Enterprises, is concerned about the date when the bonds are issued. The company really needs the cash, but she is worried that if the bonds are issued before the company's year-end (December 31, 2022) the additional liability will have an adverse effect on a number of important ratios. In July, she explains to company president William McElroy that if they delay issuing the bonds until after December 31, the bonds will not affect the ratios until December 31, 2023. They will have to report the issuance as a subsequent event, which requires only footnote disclosure. Grayson expects that with expected improved financial performance in 2023, the ratios should be better.

Instructions

a. What are the ethical issues involved?

b. Should McElroy agree to the delay?

***CA24.11 (LO 5) Groupwork (Effect of Transactions on Financial Statements and Ratios)** The transactions listed below relate to Wainwright Inc. You are to assume that on the date on which each of the transactions occurred, the company's accounts showed only ordinary shares ($100 par) outstanding, a current ratio of 2.7:1, and a substantial net income for the year to date (before giving effect to the transaction concerned). On that date, the book value per share was $151.53.

Each numbered transaction is to be considered completely independent of the others, and its related answer should be based on the effect(s) of that transaction alone. Assume that all numbered transactions occurred during 2022 and that the amount involved in each case is sufficiently material to distort reported net income if improperly included in the determination of net income. Assume further that each transaction was recorded in accordance with IFRS and, where applicable, in conformity with the all-inclusive concept of the income statement.

For each of the numbered transactions you are to decide whether it:

a. Increased the company's 2022 net income.

b. Decreased the company's 2022 net income.

c. Increased the company's total retained earnings directly (i.e., not via net income).

d. Decreased the company's total retained earnings directly.

e. Increased the company's current ratio.

f. Decreased the company's current ratio.

g. Increased each shareholder's proportionate share of total equity.

h. Decreased each shareholder's proportionate share of total equity.

i. Increased each shareholder's equity per share (book value).

j. Decreased each shareholder's equity per share (book value).

k. Had none of the these effects.

Instructions

For each transaction listed below, select from options a-k above the answer which best corresponds to each of the 9 choices. There can be more than one answer for each numbered transaction.

Transactions

______	1. In January, the board directed the write-off of certain patent rights that had suddenly and unexpectedly become worthless.
______	2. The company sold at a profit land and a building that had been idle for some time. Under the terms of the sale, the company received a portion of the sales price in cash immediately, the balance maturing at 6-month intervals.
______	3. Treasury shares originally repurchased and carried at $127 per share were sold for cash at $153 per share.
______	4. The company wrote off all of the unamortized discount (and issue costs) applicable to bonds that it refinanced in 2022.
______	5. The company called in all its outstanding ordinary shares and exchanged them for new shares on a 2-for-1 basis, reducing the par value at the same time to $50 per share.
______	6. The company paid a cash dividend that had been recorded in the accounts at time of declaration.
______	7. Litigation involving Wainwright Inc. as defendant was settled in the company's favor, with the plaintiff paying all court costs and legal fees. In 2019, the company had appropriately established a special contingency for this court action. (Indicate the effect of reversing the contingency only.)
______	8. The corporation received from its insurance company a check for the proceeds of a policy against theft of trucks. No entries concerning the theft had been made previously, and the proceeds reduce but do not completely cover the loss.
______	9. Treasury shares, which had been repurchased at and carried at $127 per share, were issued as a share dividend. In connection with this distribution, the board of directors of Wainwright Inc. had authorized a transfer from retained earnings to permanent share capital of an amount equal to the aggregate market price ($153 per share) of the shares issued. No entries relating to this dividend had been made previously.

Using Your Judgment

Financial Reporting Problem

Marks and Spencer plc (M&S)

As stated in the chapter, notes to the financial statements are the means of explaining the items presented in the main body of the statements. Common note disclosures relate to such items as accounting policies, segmented information, and interim reporting. The financial statements of **M&S** (GBR) are presented in Appendix A. The company's complete annual report, including the notes to the financial statements, is available online.

Instructions

Refer to M&S's financial statements and the accompanying notes to answer the following questions.

a. What specific items does M&S discuss in its **Note 1—Summary of Significant Accounting Policies**? (List the headings only.)

b. For what segments did M&S report segmented information? Which segment is the largest? Who is M&S's largest customer?

c. What interim information was reported by M&S?

Comparative Analysis Case

adidas and Puma

The financial statements of **adidas** (DEU) and **Puma** (DEU) are presented in Appendices B and C, respectively. The complete annual reports, including the notes to the financial statements, are available online.

Instructions

Use the companies' financial information to answer the following questions.

a. 1. What specific items does Puma discuss in its **Note 2—Significant Consolidation, Accounting, and Valuation Principles**? (Prepare a list of the headings only.)

   2. What specific items does adidas discuss in its **Note 2—Our Summary of Significant Accounting Policies**? (Prepare a list of the headings only.)

b. For what lines of business or segments do adidas and Puma present segmented information?

c. Note and comment on the similarities and differences between the auditors' reports submitted by the independent auditors of adidas and Puma for the year 2018.

*Financial Statement Analysis Case

RNA manufactures a variety of consumer products. The company's founders have run the company for 30 years and are now interested in retiring. Consequently, they are seeking a purchaser who will continue its operations. A group of investors, Morgan SA, is looking into the acquisition of RNA. To evaluate RNA's financial stability and operating efficiency, Morgan SA has requested that RNA provide its latest financial statements and selected financial ratios. RNA provides the following summary.

RNA
Income Statement
For the Year Ended November 30, 2022
(in thousands)

Sales (net)	€30,500
Interest income	500
Total revenue	31,000
Costs and expenses	
Cost of goods sold	17,600
Selling and administrative expenses	3,550
Depreciation and amortization expense	1,890
Interest expense	900
Total costs and expenses	23,940
Income before taxes	7,060
Income taxes	2,800
Net income	€ 4,260

RNA
Statement of Financial Position
As of November 30
(in thousands)

	2022	2021
Property, plant, & equipment (net)	€ 7,100	€ 7,000
Inventory	6,000	5,400
Accounts receivable (net)	3,200	2,900
Investments (at cost)	300	200
Cash	400	500
Total current assets	9,900	9,000
Total assets	€17,000	€ 16,000
Share capital—ordinary (€1 par value)	€ 2,700	€ 2,700
Share premium—ordinary	1,000	1,000
Retained earnings	5,000	4,900
Total equity	8,700	8,600
Long-term debt	2,000	1,800
Accrued expenses	1,700	1,400
Income taxes payable	900	800
Accounts payable	3,700	3,400
Total current liabilities	6,300	5,600
Total equity and liabilities	€17,000	€ 16,000

Selected Financial Ratios			
	RNA		Current Industry Average
	2021	2020	
Current ratio	1.61	1.62	1.63
Acid-test ratio	.64	.63	.68
Times interest earned	8.55	8.50	8.45
Profit margin on sales	13.2%	12.1%	13.0%
Asset turnover	1.84	1.83	1.84
Inventory turnover	3.17	3.21	3.18

Instructions

a. Calculate a new set of ratios for fiscal year 2022 for RNA based on the financial statements presented.

b. Explain the analytical use of each of the six ratios presented, describing what the investors can learn about RNA's financial stability and operating efficiency.

c. Identify two limitations of ratio analysis.

Accounting, Analysis, and Principles

Savannah plc manufactures and sells a single product. Unit sales for each of the four quarters of 2022 are projected as follows.

Quarter	Units
First	80,000
Second	150,000
Third	550,000
Fourth	120,000
Annual Total	900,000

Savannah incurs variable manufacturing costs of £0.40 per unit and variable non-manufacturing costs of £0.35 per unit. Savannah will incur fixed manufacturing costs of £720,000 and fixed non-manufacturing costs of £1,080,000. Savannah will sell its product for £4.00 per unit.

Accounting

Determine the amount of net income Savannah will report in each of the four quarters of 2022, assuming actual sales are as projected and employing (a) the integral approach to interim financial reporting and (b) the discrete approach to interim financial reporting. Ignore income taxes.

Analysis

Compute Savannah's profit margin on sales for each of the four quarters of 2022. What effect does employing the integral approach instead of the discrete approach have on the degree to which Savannah's profit margin on sales varies from quarter to quarter?

Principles

Should Savannah implement the integral or discrete approach under IFRS? Explain the conceptual rationale behind the integral approach to interim financial reporting.

Bridge to the Profession

Authoritative Literature References

[1] "Framework for the Preparation and Presentation of Financial Statements" (London, U.K.: IASB, 2001), par. 21.

[2] *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)* (London, U.K.: IASB, 2009).

[3] International Accounting Standard 1, *Presentation of Financial Statements* (London, U.K.: International Accounting Standards Committee Foundation, 2007).

[4] International Accounting Standard 24, *Related Party Disclosures* (London, U.K.: International Accounting Standards Committee Foundation, 2009), par. 9.

[5] International Accounting Standard 24, *Related Party Disclosures* (London, U.K.: International Accounting Standards Committee Foundation, 2009), par. 17.

[6] International Accounting Standard 10, *Events after the Reporting Period* (London, U.K.: International Accounting Standards Committee Foundation, 2007).

[7] International Accounting Standard 10, *Events after the Reporting Period* (London, U.K.: International Accounting Standards Committee Foundation, 2007), par. 22.

[8] International Financial Reporting Standard 8, *Operating Segments* (London, U.K.: International Accounting Standards Committee Foundation, 2006), par. BC15.

[9] International Financial Reporting Standard 8, *Operating Segments* (London, U.K.: International Accounting Standards Committee Foundation, 2006), par. 19.

[10] International Accounting Standard 34, *Interim Financial Reporting* (London, U.K.: International Accounting Standards Committee Foundation, 2001).

[11] International Accounting Standard 34, *Interim Financial Reporting* (London, U.K.: International Accounting Standards Committee Foundation, 2001), paras. B12–B19.

[12] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), par. 1.

[13] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), par. 10.

[14] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), par. 22.

[15] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), par. BC 22B.

[16] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), App. C and D.

[17] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), App. B–E.

[18] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), paras. D5–D8 and BC41–BC47.

[19] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), par. 19.

[20] International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards* (London, U.K.: IASB, 2003), par. 24.

Research Case

As part of the year-end audit, you are discussing the disclosure checklist with your client. The checklist identifies the items that must be disclosed in a set of IFRS financial statements. The client is surprised by the disclosure item related to accounting policies. Specifically, since the audit report will attest to the statements being prepared in accordance with IFRS, the client questions the accounting policy checklist item. The client has asked you to conduct some research to verify the accounting policy disclosures.

Instructions

Access the IFRS authoritative literature at the IFRS website (you may register for free IFRS access at this site). When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following questions. (Provide paragraph citations.)

a. In general, what should disclosures of accounting policies encompass?

b. List some examples of the most commonly required disclosures.

Global Accounting Insights

LEARNING OBJECTIVE 7

Compare the disclosure requirements under IFRS and U.S. GAAP.

U.S. GAAP and IFRS disclosure requirements are similar in many regards. The IFRS requirements addressing various disclosure issues are *IAS 24* (“Related Party Disclosures”), disclosure and recognition of post-statement of financial position events in *IAS 10* (“Events after the Balance Sheet Date”), segment reporting IFRS provisions in *IFRS 8* (“Operating Segments”), and interim reporting requirements in *IAS 34* (“Interim Financial Reporting”).

Relevant Facts

Following are the key similarities and differences between U.S. GAAP and IFRS related to disclosures.

Similarities

- U.S. GAAP and IFRS have similar standards on post-statement of financial position (subsequent) events. That is, under both sets of standards, events that occurred after the statement of financial position date, and which provide additional evidence of conditions that existed at the statement of financial position date, are recognized in the financial statements.

- Like U.S. GAAP, IFRS requires that for transactions with related parties, companies disclose the amounts involved in a transaction; the amount, terms, and nature of the outstanding balances; and any doubtful amounts related to those outstanding balances for each major category of related parties.
- Following the issuance of *IFRS 8*, "Operating Segments," the segment reporting requirements under U.S. GAAP and IFRS are very similar. That is, both standards use the management approach to identify reportable segments, and similar segment disclosures are required.
- Neither U.S. GAAP nor IFRS require interim reports. Rather, the U.S. SEC and securities exchanges outside the United States establish the rules. In the United States, interim reports generally are provided on a quarterly basis; outside the United States, six-month interim reports are common.

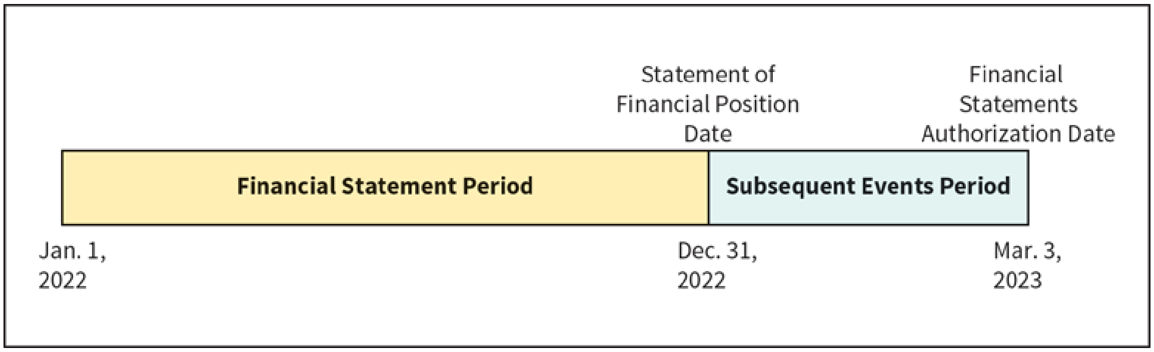
Differences

- Due to the narrower range of judgments allowed in more rules-based U.S. GAAP, note disclosures generally are less expansive under U.S. GAAP than under IFRS.
- In the United States, there is a preference for one set of accepted accounting principles except in unusual situations. The FASB issues alternative guidance (within U.S. GAAP) for privately held companies with input from the Private Company Council. As indicated in the chapter, the IASB has developed a separate set of standards for small- and medium-sized entities (SMEs), which are designed to meet the needs of privately held companies.
- As indicated in the About the Numbers section below, U.S. GAAP uses the date when financial statements are "issued" to determine the reporting of subsequent events. Subsequent (or post-statement of financial position) events under IFRS are evaluated through the date that financial instruments are "authorized for issue." Also, for share dividends and splits in the subsequent period, U.S. GAAP adjusts, but IFRS does not.
- U.S. GAAP has specific requirements to disclose the name of a related party; under IFRS, there is no specific requirement to disclose the name of the related party.
- Under U.S. GAAP, interim reports are prepared on an integral basis; IFRS generally follows the discrete approach.

About the Numbers

Post-Balance-Sheet Events (Subsequent Events)

Under U.S. GAAP (as under IFRS), notes to the financial statements should explain any significant financial events that took place after the formal balance sheet (statement of financial position) date, but before the statement is issued. These events are referred to as **post-balance-sheet events** or just plain **subsequent events**. The following illustration shows a time diagram of the subsequent events period under U.S. GAAP.



A period of several weeks and sometimes months may elapse after the end of the fiscal year but before the company issues financial statements. Various activities involved in closing the books for the period and issuing the statements take time: counting and pricing the inventory, reconciling subsidiary ledgers with controlling accounts, preparing necessary adjusting entries, ensuring that all transactions for the period have been entered, obtaining an audit of the financial statements by independent public accountants, and printing the annual report. During the period between the balance sheet date and its distribution to shareholders and creditors, important transactions or other events may occur that materially affect the company's financial position or operating situation.

Many who read a balance sheet believe the balance sheet condition is constant, and they project it into the future. However, readers must be told if the company has experienced a significant change—e.g., sold one of its plants, acquired a subsidiary, suffered extraordinary losses, settled significant litigation, or experienced any other important event in the post-balance-sheet period. Without an explanation in a note, the reader might be misled and draw inappropriate conclusions.

Relative to IFRS, which stipulates that the subsequent-event period should end on the date the statements are authorized, the subsequent-event period is longer under U.S. GAAP. Therefore, financial statement users generally receive more information about subsequent events. However, U.S. GAAP and IFRS define recognized and non-recognized subsequent events similarly. The following subsequent events disclosure is excerpted from the annual report of Commercial Metals Company.

Commercial Metals Company

NOTE 22. SUBSEQUENT EVENTS (August 31 Fiscal Year End)

On October 7, 2021, The Company announced its decision to exit the business in CMCS by way of sale and/or closure. During 2021, the Company made operational improvements in the business but not to a level which would restore profitability for the long run. Additionally, delayed entry in the European Union, cyclical demand for tubular products, unsustainable losses and increased demand for capital resources resulted in the decision to exit the business. The operation will service any existing customer commitments and the Company expects to wind down operations and liquidate inventory over the next several months. In connection with this decision, the Company expects to incur severance and other closure costs between $25 million and $40 million in fiscal 2022.

Many subsequent events or developments do not require adjustment of or disclosure in the financial statements. Typically, these are non-accounting events or conditions that management normally reports by other means. These events include legislation, product changes, management changes, strikes, unionization, marketing agreements, and loss of important customers.

Summary Observations

Because U.S. GAAP and IFRS are quite similar in their disclosure provisions, we provide some observations on the application of IFRS by foreign companies listing securities in the United States. Recently, the staff of the U.S. SEC reviewed the financial statements filed with the SEC by 100 foreign issuers, prepared for the first time using IFRS. The staff did not make any statements regarding the overall *quality* of the reports but did identify areas where additional questions might be asked. Here are some of the items that warranted staff comment:

1. Revenue recognition, especially where a company provided generic policy disclosure but did not provide disclosure specific to its circumstances.
2. Intangible assets and goodwill, including the factors that led a company to recognize them in a business combination.
3. Companies' policies for identifying and evaluating impairment, the circumstances resulting in impairment recognition, or the circumstances surrounding impairment reversals of long-lived assets, including goodwill.
4. Leases, including their terms and the future minimum payments under operating and financial leases.
5. Contingent liabilities, including their nature and estimated financial effects.
6. The significant terms of financial instruments, including derivatives, their effects on future cash flow, and the recognition and measurement criteria the company applied in accounting for financial instruments.
7. Additional issues related to income statement and cash flow statement formats and related notes.

On the Horizon

Hans Hoogervorst, chair of the IASB, recently noted: "High quality financial information is the lifeblood of market-based economies. If the blood is of poor quality, then the body shuts down and the patient dies. It is the same with financial reporting. If investors cannot trust the numbers, then financial markets stop working. For market-based economies, that is really bad news. It is an essential public good for market-based economies.... And in the past 10 years, most of the world's economies—developed and emerging—have embraced IFRSs." While the United States has yet to adopt IFRS, there is no question that IFRS and U.S. GAAP are more converged, relative to 10 years ago. We have provided expanded discussion in the *Global Accounting Insights* to help you understand the issues surrounding convergence as they relate to intermediate accounting. After reading these discussions, you will realize that IFRS and U.S. GAAP are very similar, with differences in the areas that involve minor technical points. In other areas, the differences are major; for example, IFRS does not permit LIFO inventory accounting. Our hope is that the FASB and IASB can continue convergence efforts, to narrow differences in accounting standards for use by companies around the world.

GAAP Self-Test Questions

1. Which of the following is **false?**

a. In general, IFRS note disclosures are more expansive compared to U.S. GAAP.

b. U.S. GAAP and IFRS have similar standards on subsequent events.

c. Both IFRS and U.S. GAAP require interim reports, although the reporting frequency varies.

d. Segment reporting requirements are very similar under IFRS and U.S. GAAP.

2. Which of the following is **true?**

a. Differential reporting for small- and medium-sized entities is required for all companies less than a certain size.

b. IFRS SME accounting omits accounting topics not relevant for SMEs, such as earnings per share, and interim and segment reporting.

c. U.S. GAAP provides no accounting alternatives for private companies.

d. U.S. GAAP requires significantly more disclosures, since more items are subject to judgment.

3. Subsequent events are reviewed through which date under U.S. GAAP?

a. Balance sheet (statement of financial position) date.

b. Authorization date of the financial statements.

c. Date of independent auditor's opinion.

d. Financial statement issue date.

4. Under IFRS, share dividends declared after the statement of financial position date but before the end of the subsequent events period are:

a. accounted for similarly to errors as a prior period adjustment.

b. adjusted subsequent events, because they are paid from prior year earnings.

c. not adjusted in the current year's financial statements.

d. recognized on a prospective basis from the date of declaration.

5. Interim reporting under U.S. GAAP:

a. is prepared using the discrete approach.

b. is prepared using an integral approach.

c. requires a complete set of financial statements for each interim period.

d. permits companies to omit disclosure of material events subsequent to the interim reporting date.

GAAP Concepts and Application

GAAP24.1 Briefly describe some of the similarities and differences between disclosure rules under U.S. GAAP and IFRS.

GAAP24.2 Bill Novak is working on an audit of a U.S. GAAP client. In his review of the client's interim reports, he notes that the reports are prepared on an integral basis. That is, each interim report is viewed as a part of the annual period. Is this acceptable under U.S. GAAP? If so, explain how that treatment could affect comparisons to an IFRS company.

Answers to GAAP Self-Test Questions

1. c **2.** b **3.** d **4.** d **5.** b

Notes

1 "Making Materiality Judgments," *IFRS Practice Statement 2* (London, U.K.: IASB, December 2017). Practice statements are not IFRS. Accordingly, entities are not required to comply with the framework for the preparation and presentation of management commentary as a condition for asserting compliance with IFRS.

2 The IASB is evaluating disclosure issues such as those related to management commentary. However, as noted by one standard-setter, the usefulness of expanded required disclosure also depends on users' ability to distinguish between disclosed versus recognized items in financial statements. Research to date is inconclusive on this matter. See Katherine Schipper, "Required Disclosures in Financial Reports," Presidential Address to the American Accounting Association Annual Meeting (San Francisco, Calif.: August 2005); and B. Bratten, P. Choudhary, and K. Schipper, "Evidence that Market Participants Assess Recognized and Disclosed Items Similarly When Reliability Is Not an Issue," *The Accounting Review* (July 2013).

3 Examples of related-party transactions include transactions between (a) a parent company and its subsidiaries, (b) subsidiaries of a common parent, (c) a company and trusts for the benefit of employees (controlled or managed by the enterprise), and (d) a company and its principal owners, management, or members of immediate families, and affiliates. **[4]**

4 International Standard on Auditing 240, "The Auditor's Responsibilities Related to Fraud in an Audit of Financial Statements," *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Other Related Services Pronouncements* (New York: International Federation of Accountants (IFAC), April 2010). An expanded discussion of fraud appears later in this chapter. Requirements for company audits vary according to the jurisdiction and market listing. Audits of public international companies outside the United States comply with the international auditing standards issued by the International Auditing and Assurance Standards Board (IAASB).

5 In many jurisdictions, management is required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. In such cases, the financial statements are authorized for issue—the end of the subsequent events period—when the management authorizes them for issue to the supervisory board. In other jurisdictions, companies are required to submit the financial statements to their shareholders for approval after the financial statements have been made public. In such cases, the subsequent events period ends on the date of issue, not the date when shareholders approve the financial statements. **[6]**

6 The effects from natural disasters, such as the eruption of the Icelandic volcano, which occurred after the year-end for companies with March fiscal years, require disclosure in order to keep the statements from being misleading. Some companies may have to consider whether these disasters affect their ability to continue as going concerns.

7 The estimated annual effective tax rate should reflect anticipated tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax-planning alternatives.

8 These are referred to as review engagements, which are less extensive than an audit. See International Standards on Review Engagements (ISRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity," *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Other Related Services Pronouncements* (April 2010).

9 This auditor's report and the following discussion follow international auditing standards. See International Standard on Auditing 700, "Forming an Opinion and Reporting on Financial Statements" and International Standard on Auditing 705, "Modifications to the Opinion in the Independent Auditor's Report," *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Other Related Services Pronouncements* (New York: International Federation of Accountants (IFAC), April 2010). They are also similar to the specifications for U.S. auditors contained in "Reports on Audited Financial Statements," *Statement on Auditing Standards No. 58* (New York: AICPA, 1988). U.S. standards differ due to the required audit opinion on the company's internal controls, as required by the U.S. SEC.

10 International Standards on Auditing 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (Geneva, Switzerland: The International Auditing and Assurance Standards Board, International Federation of Accountants, January 2015), para 8.

11 "Management Commentary: A Framework for Presentation," *IFRS Practice Statement*, IASB (December 2010). This is not an IFRS. Accordingly, it is not a requirement for an entity to comply with the framework for the preparation and presentation of management commentary as a condition for asserting compliance with IFRS.

12 Some areas in which companies are using financial information about the future are equipment lease-versus-buy analysis, analysis of a company's ability to successfully enter new markets, and examination of merger and acquisition opportunities. In addition, companies prepare forecasts and projections for use by third parties in public offering documents (requiring financial forecasts), tax-oriented investments, and financial feasibility studies. Use of forward-looking data has been enhanced by the increased capability of computers to analyze, compare, and manipulate large quantities of data.

13 There is not a specific international standard in this area. In the United States, see "Financial Forecasts and Projections" and "Guide for Prospective Financial Information," *Codification of Statements on Standards for Attestation Engagements* (New York: AICPA 2006), paras. 3.04 and 3.05.

14 The issue is serious. Over a recent three-year period, eight percent of the companies on the New York Stock Exchange (NYSE) were sued because of an alleged lack of financial

disclosure. Companies complain that they are subject to lawsuits whenever the share price drops. And as one executive noted, “You can even be sued if the share price goes up—because you did not disclose the good news fast enough.”

15 *Op cit.,* par. 1.02.

16 For example, the U.S. SEC Issued “Safe-Harbor Rule for Projections,” *Release No. 5993* (Washington: SEC, 1979). The U.S. Private Securities Litigation Reform Act of 1995 recognizes that some information that is useful to investors is inherently subject to less certainty or reliability than other information. By providing safe harbor for forward-looking statements, this should facilitate access to this information by investors.

17 See *www.sec.gov/rules/final/2009/33-9002.pdf* and C. Twarowski, “Financial Data ‘on Steroids’,” *Washington Post* (August 19, 2008), p. D01. See also the XBRL website for additional information.

18 PricewaterhouseCoopers, *The Global Economic Crime Survey: Economic Crime in a Downturn* (2016).

19 “Report of the National Commission on Fraudulent Financial Reporting” (Washington, D.C., 1987), p. 2. Unintentional errors as well as company improprieties (such as tax fraud, employee embezzlements, and so on) that do not cause the financial statements to be misleading are excluded from the definition of fraudulent financial reporting.

20 The discussion in this section is based on “Report of the National Commission on Fraudulent Financial Reporting,” (2004), pp. 23–24. See also “2014 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners” for fraudulent financial reporting causes and consequences.

21 Because the profession believes that the role of the auditor is not well understood outside the profession, much attention has been focused on the expectation gap. The expectation gap is the gap between (1) the expectation of financial statement users concerning the level of assurance they believe the independent auditor provides, and (2) the assurance that the independent auditor actually does provide under generally accepted auditing standards.

22 See International Standard on Auditing 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements,” *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Other Related Services Pronouncements* (April 2010).

23 Some analysts use other terms to categorize these ratios. For example, coverage ratios are sometimes referred to as *solvency* ratios; activity ratios as *turnover* or *efficiency* ratios; and coverage ratios as *leverage* or *capital structure* ratios.

24 Richard E. Cheney, “How Dependable Is the Bottom Line?” *The Financial Executive* (January 1971), p. 12.

25 See for example, Eugene A. Imhoff, Jr., Robert C. Lipe, and David W. Wright, “Operating Leases: Impact of Constructive Capitalization,” *Accounting Horizons* (March 1991).

26 To maintain comparisons in the transition year, companies may present comparative information in accordance with previous GAAP as well as the comparative information

required by IFRS. Companies must (a) label the previous GAAP information prominently as not being prepared in accordance with IFRS, and (b) disclose the nature of the main adjustments that would make it comply with IFRS. Companies need not quantify those adjustments. **[14]**

27 Other areas subject to the option are (1) business combinations; (2) insurance contracts; (3) investments in subsidiaries, jointly controlled entities, and associates; (4) designation of previously recognized financial instruments; (5) financial assets or intangible assets accounted for as Service Concession Arrangements; and (6) transfers of assets from customers. **[16]**

28 Specific implementation guidance for other areas is provided in *IFRS 1*. **[17]**

29 In addition, IFRS does not restrict the use of fair value as deemed cost to an entire class of assets, as is done for revaluation accounting (see discussion in Chapter 11). For example, a company can use fair value for deemed cost for some buildings and not for others. However, if a company uses fair value as deemed cost for assets whose fair value is above cost, it cannot ignore indications that the recoverable amount of other assets may have fallen below their carrying amount. Thus, an impairment may need to be recorded.

Source: Adapted from "Discussion Forum—Financial Reporting Disclosure," *Feedback Statement* (London, U.K.: IASB, May 2013). See also *Amendments to IAS 1* (December 2014) and *IAS 7* (January 2016).