UNIT 1

FUNDAMENTALS OF INTERNATIONAL FINANCIAL REPORTING ACCORDING TO IFRS

STUDY GOALS

On completion of this unit, you will be able to ...

- recognize the fundamentals of international financial reporting, including the characteristics of financial reporting.
- understand standard-setting in history, in the global structure, and as a political process.
- identify the types of financial statements and reporting requirements.
- explain the elements of the financial statements.
- analyze the limitations of the financial statements.
- understand the disclosure requirements for IFRS and U.S. GAAP.

1. FUNDAMENTALS OF INTERNATIONAL FINANCIAL REPORTING ACCORDING TO IFRS

Introduction

Many individuals would argue that U.S. Generally Accepted Accounting Standards (GAAP) are the 'gold standard' of accounting rules and processes. (http://www.fasb.org) International Financial Reporting Standards (IFRS) and U.S. GAAP are so very similar that the best approach to learning these sets of standards is to use one as the base of knowledge and then discuss the similarities and differences between them. Many college level textbooks take this approach.

In this unit, we will discuss the background of IFRS, the conceptual framework for both U.S. GAAP and IFRS and accounting topics, including revenue recognition, fixed assets, intangible assets, financial instruments, deferred taxes, and consolidation issues.

Imagine going to a soccer game one day and being able to follow the game's rules easily. Then, the next day, imagine going to another soccer game where the team is following an entirely different set of rules. For example, each time a team scores a goal, they get a different number of points, and penalties are calculated completely differently. That is what is happening in in our global economy in accounting, where many countries are using different accounting rules and reporting mechanisms. Comparability is not easily obtainable. Some say the answer is for the entire global community to use IFRS. More importantly, the issue is whether the use of IFRS increases financial statement information quality.

Much of the world is now using the set of accounting standards referred to as IFRS whereas countries such as the United States is still using U.S. GAAP. In fact, over 120 countries use the International Financial Reporting Standards (IFRS, 2021 *Who Uses IFRS Standards?)*

There are many more similarities than differences between U.S. GAAP and IFRS, but the differences (though relatively few in number) are significant and often based on a different worldview. Many would argue that IFRS is highly based on U.S. GAAP, which is a detailed, well-developed set of accounting standards.

One very distinct theoretical difference between U.S. GAAP and IFRS is the debate over principles versus rules. Although there is a continuum and neither set of standards is on either extreme of principles versus rules, many would argue that U.S. GAAP is more rules-based and IFRS is more principles-based. This underlying difference directly and indirectly has caused many delays in U.S. convergence with IFRS. (http://www.investopedia.com)

Since many companies from various countries own foreign subsidiaries, the decision on whether the U.S. should converge with IFRS is critical. There is a distinct benefit to the parent company if both the parent and subsidiaries use the same set of accounting standards.

1.1 Management Accounting and Financial Accounting

Accounting as a profession and field of study is much larger than many individuals realize. Accountants often specialize in a particular area, similar to what attorneys do in their law practice. Specialization areas include the following:

- Financial accounting. The creation and interpretation of financial statements. Certified Public Accountants (**CPA**s) are individuals who have passed a two-day exam.
- Management accounting. The creation of budgets, ratios, and costs of manufacturing reports. Certified Management Accountants (**CMA**s) are individuals who have passed a two-day exam.
- Tax accounting. An individual or corporate tax planning and tax returns.
- Auditing. Internal or external (independent) auditing.
- Governmental and Non-profit accounting. Accounting for a vast array of non-profit, as well as local, state, and federal accounting organizations.

CMAs & CPAs
Accountants can specialize in managerial accounting and sit for the Certified Management Accountant (CMA) exam, and/or specialize in financial accounting and sit for the Certified Public Accountant (CPA) exam.

The table shows some of the primary differences between financial and managerial accounting.

Table 1: Financial versus Managerial Accounting

	Financial accounting	**Managerial accounting**
Stakeholder focus	primarily external	primarily internal
Types of statements created	financial statements	manufacturing costs; budgets
Follows GAAP?	yes	optional
Focus on ...	... accuracy of information	... timeliness of information
Relevance or reliability?	reliability	relevance
Degree of use of estimates	medium	high

Source: Oller, 2022

1.2 Types of Financial Statements and Reporting Requirements

Fundamentals of IFRS and Financial Reporting

Accounting is often described as the language of business and a tool to provide critically important information to stakeholders, both internal and external, and to organizations. Most countries have developed some sort of system of reporting financial transactions. In underdeveloped countries, the system is basic and unsophisticated. In highly developed countries, accounting rules have evolved to match the needs of the users, i.e., investors and creditors.

Over the course of the past few decades, there has been a monumental shift towards the establishment and promulgation of a high-quality, useful set of global accounting standards. As stated above, this has occurred through the adoption of the International Financial Reporting Standards (IFRS) by most of the world. According to the IRFS, “Approximately 120 nations and reporting jurisdictions permit or require IFRS for domestic listed companies, although approximately 90 countries have fully conformed with IFRS as promulgated by the IASB and include a statement acknowledging such conformity in audit reports.” (IFRS. (2021) *Who Uses IFRS?)*. As of 2021, the United States has *not* adopted or converged with IFRS and is still using U.S. GAAP. Some other countries have their own set of GAAP, for example, Germany, which uses the German Commercial Code (HGB).

Why is it important to have convergence or adoption? Briefly highlight the importance. Provide 1 sentence difference between convergence and adoption.

The importance of comparability of the financial statements of companies across different locations is essential in the current globalized economy and financial markets. That is why IFRS adoption or the convergence of existing alternatives with IFRS standards is increasingly important.

Adoption of IFRS
This means accepting all IFRS standards instead of convergence, which means mutual agreement between the IASB and FASB.

IFRS **adoption** makes reference to the fact that countries currently using alternatives, such as U.S. GAAP, start using IFRS. In this scenario, companies in different countries would be using 100% the same standards as established by IASB. Convergence involves the development of compatible accounting standards with IFRS. In this case it involves FASB and IASB working together to reduce discrepancies between the two systems.

Having the United States either converge or adopt IFRS is critical since many companies are cross-listed on multiple security exchanges. In addition, reporting under two sets of accounting standards instead of one is a substantial cost for companies. Convergence is more likely to occur between U.S. GAAP and IFRS. The Financial Accounting Standards Board (FASB), which controls U.S. GAAP and the International Accounting Standards Board (IASB), which controls IFRS, work so closely together but neither board controls the other. Some individuals and companies advocate for adoption since convergence will not eliminate the plethora of differences between U.S. GAAP and IFRS. Adoption of IFRS is the other option for the United States.

According to the IFRS,

> In 2011, SEC staff introduced a possible method of incorporating IFRS into the U.S. financial reporting system that would represent an endorsement and convergence approach for aligning U.S. GAAP with IFRS over a period of time. Ultimately, the expectation is that the SEC will make a determination on whether it will incorporate IFRS into the financial reporting system for U.S. issuers and, if it decides to incorporate IFRS, the method of incorporation.

(IFRS. (2021) IFRS FAQs: International Financial Reporting Standards). The conceptual framework used in U.S. GAAP is a driver of all accounting rules and procedures. Think of the frame of a building. The framework helps define the exterior and interior dimensions of the building; similarly, the U.S. GAAP conceptual framework helps define the goals and objectives of financial reporting.

Qualitative characteristics of the conceptual framework

IASB and FASB are **is** the primary benefactors of a conceptual framework since the boards determine the best approach to developing highly complex accounting reporting situations.

Relevance and faithful representation are the fundamental qualitative characteristics. Relevance makes reference to the fact of providing information that can effectively bring value to the decision-making, in terms of for example changing a decision based on the information. Faithful representation is linked to the core purpose of financial reporting: the objective to provide information that effectively represents the economic and financial situation of the entity. In fact, standards development aim at increasing the accuracy of this representation, as it is essential for stakeholders. Making decisions based on information that is not representing accurately the reality of the company could lead to unexpected and undesired results.

Financial information is used as a valuable input to make important decisions (investment, lending, etc.) and counting with relevant information that faithfully represents reality in order to make choices is essential.

The enhancing qualitative characteristics of the conceptual framework include the following:

- Timeliness. This involves the communication of financial information within a reasonable amount of time after the accounting period ends. This is important because stakeholders need this information to assess a company's financial results. Timely informa-

tion is essential for decision-making, and it has become even more important in such a fast-paced changing context nowadays. Postponing decisions or not counting with valuable information on time may lead to the loss of opportunities or mistaken decisions.
- Understandability. This involves the presentation of financial information in a logical, easy-to-understand format. A reasonably prudent, informed stakeholder must be able to understand the information presented in the financial statements. Different stakeholders may be using the companies' financial information to make decisions. For financial information to be useful, it needs to be understandable.
- Verifiability. This involves a company using the same data and assumptions in recording each financial transaction that another company would use. Verifiability reinforces the solidness of faithful representation. Stakeholders must be able to rely on accurate information that comes from credible sources.

Comparability. This involves standardization in recording financial transactions and it is one of the main purposes of using the standards: having financial information from different companies which can be compared, as it has been elaborated with the same principles. Comparability from one company's financials to another's critical for decision making.

1.3 Structure of the International Financial Reporting Standards

Two Powerful Boards

As mentioned above, the two powerful forces behind the establishment of accounting rules in the United States and worldwide are the Financial Accounting Standards Board (FASB) and the **International Accounting Standards Board (IASB)**, respectively. These powerful boards have sought to achieve harmonization.

International Accounting Standards Board (IASB)
The IASB, part of the IFRS Foundation, is the independent body, integrated by a group of experts, in charge of setting or developing International Financial Reporting Standards and approving interpretations.

There are numerous reasons for the United States' delay in converging with IFRS—economic, cultural, and political. These contentious discussions have been taking place for much of the 20th century through today.

Currently, the debate ensues about whether the United States will adopt (i.e., accept the IFRS as is) or converge with IFRS. Experts who monitor this process tend to believe convergence is more likely, since some say accounting rules in the United States have set the gold standard, and it would be foolish to adopt a set of accounting rules that is already heavily based upon U.S. rules. (AICPA. (2021) *Convergence of International and U.S. Accounting Principles and IFRS).* Even without the U.S.'s convergence with IFRS, the number of countries and publicly traded companies using IFRS in part or in full has a tremendous impact on the global economy.

There are numerous positive results that have already occurred due to the significant number of countries that have adopted IFRS. Yet, there is significant push-back from many individuals and companies in the U.S. about convergence with IFRS. The European Union adopted IFRS in 2005 with only a few exceptions. Several years earlier, in 2002, the European Parliament and European Council of Ministers both agreed to require use of IFRS. (ICAEW, 2021) *IFRS adoption and endorsement in the EU).*

Primary Users of IFRS

Publicly traded companies that are listed on a stock exchange are the most common users of IFRS. These IFRS standards are established by the IASB. The establishment and use of a global set of high-quality standards supposedly will benefit all countries. It assumed that using one set of accounting standards world-wide will result in a higher level of accountability and economic efficiency.

It must be noted that some countries that have adopted IFRS standards are not requiring it for all companies in all situations. Sometimes, the country mandates use of IFRS in full by all companies, sometimes only for publicly traded companies, and sometimes the decision is up to the individual company within that country.

Standard Setters' Role

Standard setters continually work towards developing standards that reflect accurate financial information with the use of concepts, rules, and guidelines for accountants to follow. Transparency and accuracy are key goals of this process. The two boards—the IASB and the FASB—carry a tremendous level of responsibility to world capital markets via development of accounting standards. In 2004, these two boards commenced work on a joint project to revise and converge their respective conceptual frameworks. This work continued through late 2010, at which time they agreed to postpone their joint efforts. In early 2014, FASB returned to work on their conceptual framework project which focuses on presentation and measurement. (http://www.fasb.org)(FASB.(2021))

Importance of Understanding IFRS

In a global economy, with a significant number of companies operating in foreign countries, the need for comparability is key since utilizing different accounting rules will yield different financial results. Many U.S.-based companies own and operate subsidiaries which report under IFRS, so U.S. convergence with IFRS will eliminate the need for these companies to report their financials under both sets of standards. Many companies and individuals rely on the IFRS website, ifrs.org to obtain the most current, accurate information on all aspects of IFRS. There is a plethora of information on this site, most of which is free.

The Securities and Exchange Committee (SEC) plays a huge role in establishing rules about companies that trade their shares on the U.S. stock exchanges. The SEC does allow use of IFRS-based financial statements by international companies trading on the U.S. stock exchanges. The SEC plays an important role in development and promotion of "high-quality, globally accepted accounting standards" (SEC, 2021 Global Accounting Standards).

Transparency, accountability, and efficiency in capital markets

As mentioned above, many agree that the IASB that IFRS standards provide much-needed transparency in financial information. This high-quality set of standards is often seen as filling a knowledge gap for individuals who are investing in capital markets, while also provides a higher level of accountability from companies who create and publish their financials.

Who benefits from companies' adherence to IFRS standards?

Some individuals will benefit more than others when using IFRS standards. These individuals can include the following:

- Individuals who rely on the accurate depiction of financial results around the world.
- Investors in global markets who can capitalize on investing opportunities, resulting in more effective capital allocation.
- Companies seeking to reduce their international accounting reporting costs which affects the cost of capital.

(https://www.ifrs.org/use-around-the-world/why-global-accounting-standards)(IFRS. (2021) *Why global accounting standards?)*

Standard-Setting History

Until recently, most of the 195 countries in the world had developed and followed their own set of accounting rules and standards, which resulted in very little comparability when analyzing different companies' financials. On a global scale, creditors and investors were unable to make informed decisions about a company's financial strengths and weaknesses. This issue had been detrimental to global capital markets.

Thus, in 1973, the International Accounting Standards Committee (IASC) was organized to increase comparability in reporting standards. By the 1990s, their goal was to develop and promote a cohesive, understandable set of standards. Eventually, the IASB replaced the IASC since the IASC had too many limitations in its structure. (Deloitte (2021) *About the International Accounting Standards Committee (IASC)*). The IASB develops and promulgates IFRS. On an even larger scale, there are other related organizations that work together, including the IFRS foundation, the Monitoring Board, founded in 2009 (IFRS (2021), *IFRS Foundation Monitoring Board*, para.1), the IFRS advisory council, and the IFRS Interpretations Committee. The IASB closely monitors standards post-implementation to maintain control of the standard development process.

1.4 Elements of Financial Statements

Types of financial statements and reporting requirements

As discussed above, the Financial Accounting Standard Board (FASB) and the International Accounting Standard Board (IASB), along with the SEC work together and separately in the development of U.S. GAAP and IFRS. Interestingly, IFRS standards are still evolving, as new questions and challenges arise from their implementation and new business realities.

Key Elements of Financial Reporting

The four primary elements of financial reporting are: (1) financial information gathered for (2) an economic entity for (3) user groups within a specific (4) Legal, economic, political, and social environment.

(1) financial information is the object of financial reporting. It includes different types of information to provide a faithful representation of the situation of the company, regarding for example its performance and its financial situation.

(2) an economic entity is the subject of the financial reporting, whose information is reported. It can be a legal entity when the financial reporting corresponds to its individual financial statements and information or otherwise a consolidated group, which is made of different legal entities that are related and act as an economic entity. Groups and consolidated financial statements will be explained in unit 8.

(3) user groups means the different stakeholders that will be using financial statements and companies' financial information as a key source for their decision making. This involves a variety of stakeholders such as existing and potential investors, analysts, banks or potential creditors, institutions, etc.

(4) the legal, economic, political and social environment makes reference to the context and the variety of stakeholders. Companies are not isolated entities but interact within their context and they can have a significant impact on it. That is why stakeholders from these different areas can be interested into obtaining information about the company.

This process involves identification, measurement, and communication of financial information to numerous groups for them to make informed decisions. One primary goal of financial statements is to provide information to shareholders that is relevant to their investment decision-making process. Financial statements should be detailed enough to provide useful information to shareholders as well as other stakeholders, such as creditors.

Both U.S. GAAP and IFRS require issuance of four primary financial statements. The naming of these statements can vary slightly but, for the most part, the components on each set of statements are similar. The statements' components are as follows:

1. The income statement contains revenue and expenses. Income Statements may also include gains and losses which are not from daily operations, and result in either net income or net loss. Income statements are often referred to as 'Profit and Loss' Statements, or P & L.
2. The statement of owners' equity shows the amount of capital, i.e., investment that owner(s) have in the business. This statement links the income statement to the balance sheet and is often not provided to stakeholders. The result of this statement is ending capital, which then rolls over to the balance sheet.
3. The balance sheet contains assets, liabilities, and capital. This statement is often characterized as showing the financial strength of an organization. It contains permanent accounts that roll over from period to period.
4. The statement of cash flows consists of three sections: operating, investing, and financing. The statement reflects how changes in many accounts (primarily from the current and previous year's balance sheet) affects changes in cash during the reporting period.

Table 2: Naming Differences between U.S. GAAP and IFRS

US GAAP	IFRS
Income statement	Statement of profit and loss
Statement of owners' equity	Statement of changes in equity
Balance sheet	Statement of financial position
Statement of cash flows	Statement of cash flows

Source: Oller, 2022

IFRS-based companies often include a statement of comprehensive income which starts with the income statement components of revenue and expenses. U.S. companies have the option to provide stakeholders with the statement of comprehensive income, but it is not commonly prepared. For both sets of standards, the statement of comprehensive income will have a little variation. IFRS-based companies are allowed to revalue their assets so the unrealized gains and losses on IFRS based companies can be significant. For companies reporting under IFRS, in case they report the statement of profit and loss, they need to present as well the statement of other comprehensive income.

Income statement or Statement of Profit and Loss

The income statement is an essential source of financial information of a company as it provides information on its performance during the reporting period, being key to assess its profitability during that time. It includes the revenues of the business as well as the costs and expenses needed to reach them, in the said period. In financial reporting the main reporting period is the fiscal year, although quarterly reporting is sometimes required as well.

Under IAS 1 Presentation of Financial Statements, entities can choose between presenting together in one **Statement of Comprehensive Income** all the income and expenses of the period or otherwise presenting them into two statements: a statement that presents the items of profit and loss for the period, this is the Statement of Profit and Loss and a Statement of Other Comprehensive Income. (BDO (2021), *IFRS at a glance*).

Statement of Comprehensive Income
It is a financial statement that includes the information from both the statements of profit and loss and other comprehensive income, this is all the income and expenes of the reporting period.

$$\text{Comprehensive income for the period} = \text{Profit or loss} + \text{Other comprehensive income}$$

IAS 1 — Presentation of Financial Statements, sets a minimum of lines to be included in the statement of profit and loss:

- Revenues
- Financial costs
- Losses and gains from financial assets derecognition (when measured at amortized cost)
- Corresponding profits and losses from joint ventures and associates, recognized with the equity method
- Some losses or gains related to financial assets reclassification
- Tax expense
- A single amount as a result of the total of discounted items.

Expenses can be grouped according to their nature (raw materials purchases, labor, depreciation, etc.) or according to their function (for example cost of sales, which can involve raw materials, some labor, etc.). In this second case, additional disclosure of the nature is required.

(Deloitte (2022), *IAS 1 — Presentation of Financial Statements*)

In the example below, the income statement of Adidas for 2020, additional lines are presented, and the expenses are showed according to their function which can be very relevant information for stakeholders to better understand the business results.

Figure 1: Income Statement example: Adidas, 2020

adidas AG Consolidated Income Statement (IFRS) € in millions

	Note	Year ending Dec. 31, 2020	Year ending Dec. 31, 2019	Change
Net sales	38	19,844	23,640	(16.1%)
Cost of sales		9,990	11,347	(12.0%)
Gross profit		**9,855**	**12,293**	**(19.8%)**
(% of net sales)		49.7%	52.0%	(2.3pp)
Royalty and commission income		83	154	(46.2%)
Other operating income	31	42	56	(24.5%)
Other operating expenses	11, 14, 32, 33	9,229	9,843	(6.2%)
(% of net sales)		46.5%	41.6%	4.9pp
Marketing and point-of-sale expenses		2,573	3,042	(15.4%)
(% of net sales)		13.0%	12.9%	0.1pp
Distribution and selling expenses		4,962	4,997	(0.7%)
(% of net sales)		25.0%	21.1%	3.9pp
General and administration expenses		1,461	1,652	(11.6%)
(% of net sales)		7.4%	7.0%	0.4pp
Sundry expenses		119	134	(11.6%)
(% of net sales)		0.6%	0.6%	0.0pp
Impairment losses (net) on accounts receivable and contract assets		114	18	541.8%
Operating profit		**751**	**2,660**	**(71.8%)**
(% of net sales)		3.8%	11.3%	(7.5pp)
Financial income	34	29	64	(55.2%)
Financial expenses	34	204	166	23.2%
Income before taxes		**575**	**2,558**	**(77.5%)**
(% of net sales)		2.9%	10.8%	(7.9pp)
Income taxes	36	146	640	(77.2%)
(% of income before taxes)		25.4%	25.0%	0.3pp
Net income from continuing operations		**429**	**1,918**	**(77.6%)**
(% of net sales)		2.2%	8.1%	(6.0pp)
Gain from discontinued operations, net of tax	03	13	59	(77.5%)
Net income		**443**	**1,977**	**(77.6%)**
(% of net sales)		2.2%	8.4%	(6.1pp)
Net income attributable to shareholders		**432**	**1,976**	**(78.1%)**
(% of net sales)		2.2%	8.4%	(6.2pp)
Net income attributable to non-controlling interests		**11**	**2**	**540.9%**
Basic earnings per share from continuing operations (in €)	37	**2.15**	**9.70**	**(77.9%)**
Diluted earnings per share from continuing operations (in €)	37	**2.15**	**9.70**	**(77.9%)**
Basic earnings per share from continuing and discontinued operations (in €)	37	**2.21**	**10.00**	**(77.8%)**
Diluted earnings per share from continuing and discontinued operations (in €)	37	**2.21**	**10.00**	**(77.8%)**

Source: (Adidas (2021), Annual Report 2020)

Figure 2: Statement of Comprehensive Income example: Adidas, 2020

adidas AG Consolidated Statement of Comprehensive Income (IFRS) € in millions

	Note	Year ending Dec. 31, 2020	Year ending Dec. 31, 2019
Net income after taxes		**443**	**1,977**
Items of other comprehensive income that will not be reclassified subsequently to profit or loss			
Remeasurements of defined benefit plans (IAS 19), net of tax[1]	25	(15)	(50)
Net (loss) / gain on other equity investments (IFRS 9), net of tax	30	(2)	12
Subtotal of items of other comprehensive income that will not be reclassified subsequently to profit or loss		**(17)**	**(38)**
Items of other comprehensive income that will be reclassified to profit or loss when specific conditions are met			
Net loss on cash flow hedges and net foreign investment hedges, net of tax	30	(100)	(148)
Net gain / (loss) on cost of hedging reserve – options, net of tax	30	7	(7)
Net (loss) / gain on cost of hedging reserve – forward contracts, net of tax	30	(30)	11
Reclassification of foreign currency differences due to dissolution of subsidiaries		–	0
Currency translation differences		(401)	98
Subtotal of items of other comprehensive income that will be reclassified to profit or loss when specific conditions are met		**(524)**	**(46)**
Other comprehensive income		**(540)**	**(84)**
Total comprehensive income		**(97)**	**1,894**
Attributable to shareholders of adidas AG		(87)	1,898
Attributable to non-controlling interests		(10)	(4)

1 Includes actuarial gains or losses relating to defined benefit obligations, return on plan assets (excluding interest income) and the asset ceiling effect.
The accompanying Notes are an integral part of these consolidated financial statements.

Source: (Adidas (2021), Annual Report 2020)

Income statements are useful in that shareholders can evaluate past performance in a company's level of revenues and expenses. Based on past performance, shareholders can estimate, with some degree of confidence, a company's future profitability. They can also assess risk or uncertainties regarding the company's future cash flows with the understanding that some items on the income statement will continue year over year and some will be transitory in nature.

There are also numerous limitations to the income statement since there are items that are excluded. This would include any items such as revenues, expenses, gains, and losses that cannot be measured reliably. In addition, depending on which accounting treatments are chosen, results on the income statement will vary. An example of this would be inventory valuation method decisions. The conceptual framework requires comparability between companies' financials, but with so much judgment and estimations involved, that principle cannot always be adhered to.

Balance Sheet or Statement of financial position

The balance sheet or statement of financial position reflects the financial strength of an organization at a concrete moment in time. In financial reporting, this is the end of the reporting period. It shows the company resources and obligations at that moment, classified into different types. It contains permanent accounts, which are assets, liabilities, and capital or shareholders equity. Its fundamental balance equation is as follows:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' equity}$$

Distinction between non-current and current assets and liabilities is important unless otherwise the entity presents reliable information with the liquidity criteria. (Deloitte (2022), *IAS 1 — Presentation of Financial Statements*)

Minimum Reporting Requirements for IFRS:

Companies must report the following asset categories:

- cash and cash equivalents
- trade and other receivables
- investments accounted for using the equity method
- financial assets
- inventories
- property, plant, and equipment
- biological assets
- investment properties
- intangible assets
- receivables related to current taxes
- deferred-tax assets

Companies must report the following liability categories:

- trade and other payables
- provisions (such as warranty, liabilities, and pension benefits)
- financial liabilities
- taxes payable
- deferred tax liability (http://www.ifrs.org)

Typically, companies reporting under U.S. GAAP tend towards listing current assets before noncurrent assets and current liabilities before noncurrent liabilities. IFRS-reporting companies have the option to follow the same structure or reverse them and put the noncurrent items first. IFRS-based companies have flexibility on how they format their balance sheets.

An example of balance sheet can be seen below, continuing with the example of Adidas.

Figure 3: Balance Sheet example: Adidas, 2020 (I)

adidas AG Consolidated Statement of Financial Position (IFRS) € in millions

	Note	Dec. 31, 2020	Dec. 31, 2019	Change in %
Assets				
Cash and cash equivalents	05	3,994	2,220	80
Short-term financial assets	06	0	292	(100)
Accounts receivable	07	1,952	2,625	(26)
Other current financial assets	08	702	544	29
Inventories	09	4,397	4,085	8
Income tax receivables	36	109	94	17
Other current assets	10	999	1,076	(7)
Assets classified as held for sale		0	–	n.a.
Total current assets		**12,154**	**10,934**	**11**
Property, plant and equipment	11	2,157	2,380	(9)
Right-of-use assets	12	2,430	2,931	(17)
Goodwill	13	1,208	1,257	(4)
Trademarks	14	750	859	(13)
Other intangible assets	14	252	305	(18)
Long-term financial assets	15	353	367	(4)
Other non-current financial assets	16	414	450	(8)
Deferred tax assets	36	1,233	1,093	13
Other non-current assets	17	103	103	(1)
Total non-current assets		**8,899**	**9,746**	**(9)**
Total assets		**21,053**	**20,680**	**2**

Source: Adidas (2021), Annual Report 2020

The balance sheet information reflects financial resources and associated obligations, as well as implied required rate of return on investments and risk associated with the company. For U.S. GAAP-based companies, most of the accounts on the balance sheet are reported at original, historical cost instead of market values or liquidation values.

Figure 4: Balance Sheet example: Adidas, 2020 (II)

adidas AG Consolidated Statement of Financial Position (IFRS) € in millions

	Note	Dec. 31, 2020	Dec. 31, 2019	Change in %
Liabilities and equity				
Short-term borrowings	18	686	43	1,483
Accounts payable		2,390	2,703	(12)
Current lease liabilities	21	563	733	(23)
Other current financial liabilities	19	446	235	90
Income taxes	36	562	618	(9)
Other current provisions	20	1,609	1,446	11
Current accrued liabilities	22	2,172	2,437	(11)
Other current liabilities	23	398	538	(26)
Total current liabilities		**8,827**	**8,754**	**1**
Long-term borrowings	18	2,482	1,595	56
Non-current lease liabilities	21	2,159	2,399	(10)
Other non-current financial liabilities	24	115	92	24
Pensions and similar obligations	25	284	229	24
Deferred tax liabilities	36	241	280	(14)
Other non-current provisions	20	229	257	(11)
Non-current accrued liabilities	22	8	9	(9)
Other non-current liabilities	26	17	7	156
Total non-current liabilities		**5,535**	**4,868**	**14**
Share capital		195	196	(0)
Reserves		(474)	45	n.a.
Retained earnings		6,733	6,555	3
Shareholders' equity	**27**	**6,454**	**6,796**	**(5)**
Non-controlling interests	29	237	261	(9)
Total equity		**6,691**	**7,058**	**(5)**
Total liabilities and equity		**21,053**	**20,680**	**2**

Source: Adidas (2021), Annual Report 2020

Limitations of the balance sheet reside on the fact that many items that have value cannot be reported on the balance sheet, such as human capital and the organization's reputation. Estimates are widely used when reporting certain items, such as net realizable value, which reflects the amount of accounts receivable that the company expects to collect. Cash flow and the cash generation capacity of a company are important indicators to both companies and stakeholders. Important concepts related to the company's capacity to generate cash based on their balance sheet are the following:

- Liquidity, which measures how easily and soon an asset can be turned into cash.
- Solvency, which reflects an organization's capacity to meet their long-term financial obligations.
- Financial flexibility, which reflects how well a company can respond to unexpected financial needs.

The Statement of Cash Flows:

The statement of Cash Flows is addressed on IAS 7 Statement of Cash Flows, and it reflects the cash outflows and inflows for the period (usually the fiscal year). This statement is structured in three main parts: cash from operating activities (main activities of the company, operations not involving investment or financing), cash from investing activities (related to transactions of long-term assets) and cash from financing activities (related to borrowings and equity). This classification provides useful information that can be helpful to understand the sources and uses of cash for the period.

The cash from operating activities can be reported using two different methods. In the indirect method, the starting point is the profit or loss which is adjusted with the changes of working capital in the period (inventories, trade receivables and payables), the non-cash elements (depreciation and amortization, provisions, etc.) and the items that involve cash flows from investing or financing operations. In the direct method, the net cash of operating activities is displayed as cash inflows or outflows from different items that affect the cash flow, such as customers, suppliers, employees, operating expenses, interests, etc.

The statement of cashflows shows as well the reconciliation between cash at the beginning of the period and cash at the end of the period, as it can be observed in the example below. Cash from operating activities is presented with the indirect method, taking income before taxes as the starting point.

Figure 5: Statement of Cash Flows example: Adidas, 2020 (I)

adidas AG Consolidated Statement of Cash Flows (IFRS) € in millions

	Note	Year ending Dec. 31, 2020	Year ending Dec. 31, 2019
Operating activities:			
Income before taxes		575	2,558
Adjustments for:			
Depreciation, amortization and impairment losses	11, 12, 13, 14, 32, 34	1,370	1,214
Reversals of impairment losses	31	(6)	(8)
Interest income	34	(25)	(50)
Interest expense	34	164	160
Unrealised foreign exchange losses/(gains), net		35	(1)
Losses on sale of property, plant and equipment and intangible assets, net		28	11
Other non-cash effects from operating activities	31, 32	2	(12)
Payment for external funding of pension obligations (CTA)		–	(105)
Operating profit before working capital changes		**2,144**	**3,767**
Decrease/(Increase) in receivables and other assets		394	(694)
Increase in inventories		(503)	(505)
(Decrease)/Increase in accounts payable and other liabilities		(141)	951
Cash generated from operations before taxes		**1,893**	**3,519**
Income taxes paid		(404)	(692)
Net cash generated from operating activities – continuing operations		**1,489**	**2,828**
Net cash used in operating activities – discontinued operations		(3)	(9)
Net cash generated from operating activities		**1,486**	**2,819**
Investing activities:			
Purchase of trademarks and other intangible assets		(64)	(110)
Proceeds from sale of trademarks and other intangible assets		4	0
Purchase of property, plant and equipment		(379)	(598)
Proceeds from sale of property, plant and equipment		17	13
Proceeds from sale of a disposal group	03	1	8
Proceeds due to business combinations	04	–	54
Proceeds from disposal of discontinued operations		41	20
Proceeds from/ (Purchase of) sale of short-term financial assets		289	(284)
Purchase of investments and other long-term assets		(49)	(80)
Interest received		25	50
Net cash used in investing activities – continuing operations		**(115)**	**(925)**
Net cash generated from investing activities – discontinued operations		–	–
Net cash used in investing activities		**(115)**	**(925)**
Financing activities:			

Source: Adidas (2021), Annual Report 2020

Figure 6: Statement of Cash Flows example: Adidas, 2020 (II)

adidas AG Consolidated Statement of Cash Flows (IFRS) € in millions

	Note	Year ending Dec. 31, 2020	Year ending Dec. 31, 2019
Proceeds from issuance of bonds	18	1,490	–
Reverse transaction of buyback of Eurobonds	18	11	–
Interest paid		(157)	(156)
Repayments of lease liabilities		(611)	(597)
Dividend paid to shareholders of adidas AG	27	–	(664)
Dividend paid to non-controlling interest shareholders		(17)	(2)
Repurchase of adidas AG shares	27	(257)	(809)
Repurchase of adidas AG shares due to share-based payments		(29)	(28)
Proceeds from reissuance of treasury shares due to share-based payments		25	24
Proceeds from short-term borrowings	18	543	–
Repayments of short-term borrowings	18	(519)	(42)
Net cash generated from/(used in) financing activities – continuing operations		**479**	**(2,273)**
Net cash generated from financing activities discontinued operations			
Net cash generated from/(used in) financing activities		**479**	**(2,273)**
Effect of exchange rates on cash		**(75)**	**(30)**
Increase /(Decrease) in cash and cash equivalents		1,774	(410)
Cash and cash equivalents at beginning of year	05	2,220	2,629
Cash and cash equivalents at end of period	**05**	**3,994**	**2,220**

Source: Adidas (2021), Annual Report 2020

The Statement of Stockholders' Equity:

The statement of stockholders' equity is required under IFRS but not under U.S. GAAP. There are numerous items in the statement of stockholders' equity, although not all of them apply to all companies. They can include the following: contributed capital accounts related to investments by owners; common and preferred stock; retained earnings, including net income (loss) and distributions to owners (dividends); accumulated and other comprehensive income (referred to as "reserves" under IFRS); Treasury stock—this is stock that the company repurchases from shareholders and noncontrolling interest—if and when a company purchases a percentage of another company (Gordon, E.A, Raedy, J.S., Sannella, A.J. (2021) *Intermediate Accounting*).

The statement of stockholders' equity is required under IFRS but not under U.S. GAAP. In the example below, it can be observed how it presents a reconciliation between the opening balance of the different concepts included into equity and their closing balance at the end of the reporting period, in this case December 31, 2020, detailing the different actions that generated these changes.

Figure 7: Statement of Changes in Equity example: Adidas 2020

adidas AG Consolidated Statement of Changes in Equity (IFRS) € in millions

	Note	Share capital	Capital reserve	Cumulative currency translation differences	Hedging reserve	Cost of hedging reserve options	Cost of hedging reserve forward contracts	Other reserves	Retained earnings	Shareholders' equity	Non-controlling interests	Total equity
Balance at January 1, 2019		**199**	**887**	**(574)**	**(3)**	**(3)**	**(5)**	**(180)**	**6,054**	**6,377**	**(13)**	**6,364**
Other comprehensive income				104	(147)	(7)	11	(38)		(78)	(6)	(84)
Net income									1,976	1,976	2	1,977
Total comprehensive income				**104**	**(147)**	**(7)**	**11**	**(38)**	**1,976**	**1,898**	**(4)**	**1,894**
Repurchase of adidas AG shares	27	(3)							(806)	(809)		(809)
Repurchase of adidas AG shares due to equity-settled share-based payment	27	(0)							(28)	(28)		(28)
Reissuance of treasury shares due to equity-settled share-based payment	27	0							32	32		32
Dividend payment									(664)	(664)	(2)	(666)
Equity-settled share-based payment	28								(10)	(10)		(10)
First-time consolidation due to obtaining control in accordance with IFRS 10	04										280	280
Balance at December 31, 2019 / January 1, 2020		**196**	**887**	**(470)**	**(150)**	**(10)**	**6**	**(218)**	**6,555**	**6,796**	**261**	**7,058**
Other comprehensive income				(380)	(100)	7	(30)	(17)		(519)	(21)	(540)
Net income									432	432	11	443
Total comprehensive income				**(380)**	**(100)**	**7**	**(30)**	**(17)**	**432**	**(87)**	**(10)**	**(97)**
Repurchase of adidas AG shares	27	(1)							(263)	(264)		(264)
Repurchase of adidas AG shares due to equity-settled share-based payment	27	(0)							(29)	(29)		(29)
Reissuance of treasury shares due to equity-settled share-based payment	27	0							36	36		36
Dividend payment											(17)	(17)
Equity-settled share-based payment	28								2	2		2
First-time consolidation due to obtaining control in accordance with IFRS 10	04										3	3
Balance at December 31, 2020		**195**	**887**	**(850)**	**(250)**	**(3)**	**(23)**	**(235)**	**6,733**	**6,454**	**237**	**6,691**

The accompanying Notes are an integral part of these consolidated financial statements.

Source: Adidas (2021), Annual Report 2020

Notes to the Financial Statements

IAS 1 requires the notes to be part of the financial statement reporting set. The notes contain the main accounting policies as well as other relevant explanations, such as assumptions, estimates, judgements, and other insights which can be material for the decision-making.

Even if usually there is a strong focus on each of the financial statements and the notes seem to have a secondary role, their function is essential, as they contain important information for an accurate understanding of the financial statements and allow stakeholders to better assess the comparability of the financial information of different companies or different reporting periods.

Part of the notes make reference to general accounting policies, whereas others are specific to the different items on the financial statements, to provide further insights, assumptions and required disclosures. In the example below, this is the beginning of the notes regarding the balance sheet.

Figure 8: Notes to the financial statements example: Adidas, 2020

NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

05 CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of cash held by banks, cash on hand and short-term deposits.

Short-term deposits are only shown as cash and cash equivalents if they are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value. The credit risk of cash and cash equivalents measured at amortized cost is insignificant due to their short-term maturity, counterparties' investment grade credit ratings and established exposure limits. Therefore, adidas does not recognize any credit impairment losses for these financial assets.

Further information about cash and cash equivalents is presented in these Notes. ▸ SEE NOTE 30

06 SHORT-TERM FINANCIAL ASSETS

Short-term financial assets are classified at fair value through profit or loss. Changes in the fair value are recognized in the consolidated income statement as they occur. The short-term financial assets are marketable securities which are mainly investments in money market funds.

07 ACCOUNTS RECEIVABLE

Accounts receivable consist mainly of the currencies US dollar, euro as well as Chinese renminbi and are as follows:

Accounts receivable € in millions

	Collective loss allowance				Individual loss allowance	Total
	Not yet due	Past due 31 – 90 days	Past due > 90 days			
	Not credit-impaired	Not credit-impaired	Not credit-impaired	Credit-impaired	Credit-impaired	
Dec. 31, 2020						
Accounts receivable, gross	1,699	235	27	55	203	2,219
Weighted average loss rate	0.7%	4.9%	29.0%	61.5%	98.8%	12.0%
Loss allowance	(13)	(12)	(8)	(34)	(201)	(267)
Accounts receivable, net	**1,686**	**224**	**19**	**21**	**2**	**1,952**
Dec. 31, 2019						
Accounts receivable, gross	2,329	286	25	34	139	2,814
Weighted average loss rate	0.7%	4.3%	39.1%	59.5%	92.9%	6.7%
Loss allowance	(17)	(12)	(10)	(20)	(129)	(189)
Accounts receivable, net	**2,312**	**274**	**15**	**14**	**10**	**2,625**

Source: Adidas (2021), Annual Report 2020

Principles versus Rules

Many experts in the accounting profession maintain that U.S. GAAP is more rules-based, while IFRS is more principles-based. However, if one were to draw a continuum, with rules on one end and principles on the other, neither U.S. GAAP nor IFRS would be the limit at either end. Instead, they would show tendencies toward being rules-based or principles-based without falling squarely into one category. The discussion about principles versus rules can be compared to the discussion of “substance over form,” where substance (what really is happening in a situation) are the principles involved, and form are the rules being followed (possibly blindly in order to conform with rules; IFRS, 2021).

A common example of the principles versus rules debate is related to the classification of leases. IFRS maintains that the intent of the organization in classifying leases, and thus the accounting rules followed for that type of lease, is more important than classifying based on a rule or threshold. U.S. GAAP follows a more rigid approach with rules that dictate which category a lease will fall into.

Disclosures

Although the notes with IFRS- and U.S. GAAP-based companies are similar, IFRS often requires a higher level of disclosure with additional items. IFRS disclosures include a company’s overall objectives, policies, and approaches for capital management. IFRS disclosures are typically more detailed than U.S. GAAP disclosures and IFRS disclosures often include reconciliations. IFRS requires that the following items are disclosed:

- Sources of uncertainty when measuring assets and liabilities.
- Subsequent events, meaning that companies are required to disclose the authorization date of the financial statements and the person who authorized them.
- Going concern one-year within the financial statement date.
- Related-party transactions, which include disclosing executive compensation.
- Sources of estimation uncertainty if there is a high risk of significant revision to the carrying amounts of the assets and liabilities within the next 12 months.

(Gordon, E.A., Raedy, J.S., Sannella, A.J. (2021) *Intermediate Accounting*)

SUMMARY

Global capital markets are significantly affected by the accounting standards chosen by individual countries. The most widely accepted set of accounting standards are referred to as IFRS, which is currently used by over 120 countries. U.S. GAAP and IFRS are very similar, but the differences that do exist mean that U.S. convergence with IFRS is unlikely. The principles versus rules debate does have an impact on many aspects of financial transaction reporting, and while U.S. GAAP and IFRS are very similar, there are still some areas that the Financial Accounting Standards Board and the International Accounting Standards Board cannot agree upon.

Accounting is the language of business and financial statements provided by accountants give a significant amount of information to stakeholders. The income statement, statement of owners' equity, balance sheet, and statement of cash flows all provide insights into the operations and financial strength of an organization. Additionally, financial analysis is important since knowing a company's liquidity, solvency, and financial flexibility adds further dimensions of information. There are limitations to the amount of information that can be captured in the income statement and the balance sheet, so stakeholders should also review additional sources of information, such as a company's estimates and revenue recognition policies.