International Financial Accounting

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Session 2

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Balance sheet

Intro to balance sheet

AutoDesk & Ayden

Balance sheet

The balance sheet "balances" because:

investments = finance used to pay for investments

investments = equity finance + debt finance

assets = equity + liabilities

The balance sheet outlines the:

- Investments made by the firm
- How the investments have been financed – equity / debt

Balance sheet equation

Investments = Sources of finance

Assets = Equity + Liabilities

Can rearrange this:

- Equity = Assets - Liabilities

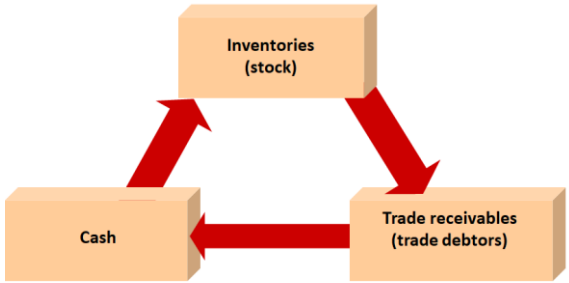
Balance sheet

The first section of the balance sheet tells you the investments / resources / assets available to the company:

- Non-current assets / long-term: the productive capacity of the



- Current assets / short-term: working capital



Session 2: Balance sheet

Introduction

General measurement tools

Investments / non-current assets

- Productive

Operating
Financing

Note: the categories are linked to the cash flow statement to make it easier for you to establish links

Recap: English terminology

The Balance Sheet

Assets
Cash
Short-Term Investment
Accounts Receivable
Notes Receivable
Inventory (to be sold)
Supplies
Prepaid Expenses
Long-Term Investments
Equipment
Buildings
Land
Intangibles

Liabilities
Accounts Payable
Accrued Expenses
Notes Payable
Taxes Payable
Unearned Revenue
Bonds Payable

Stockholders' Equity
Contributed Capital
Retained Earnings

General measurement tools

Common tools/concepts used across standards

Measuring assets

Entry vs exit value

Measurement

Typically the standards for non-current assets permit two measurement bases:

1. Historical Cost
2. Fair Value

The method selected will impact on income statement / balance sheet differently

When analysing accounting information – be aware of the differences in accounting policies

Entry vs exit value

Historical cost = entry price

price you paid when you initially purchased the item

i.e. the value of the asset when it **entered** the company

Fair value = exit price

market price you would receive if you sold the item today

i.e. the value you would receive for the asset if it **exited** the company

This logic will become important in a moment !

Historical cost

Item is measured at historical monetary cost at the purchase date

The cost may differ from the current market value

The item must be depreciated/amortised & tested for impairment

Depreciation/amortisation

- Process to allocate cost of asset to income statement – to match the depletion of the resource to the revenues it helps to generate
- Total depreciation held in a contra-account on the balance sheet called **Accumulated Depreciation**

Impairment

- Under IAS 36: test whether the cost of the asset is impaired i.e. needs to be written downwards

Fair value

Item periodically measured based on current market price

Must follow the hierarchy in IFRS 13 – Fair Value Measurement when estimating fair value

Accounting for a change in the fair value of an item between 2 measurement dates depends on the standard

Which measurement base is most appropriate?

It depends on the intended use of the asset

2 ways to recover the value of an asset:

1. Use
2. Sale

Which measurement base is most appropriate for use?

For sale?

Which measurement base is most appropriate?

if you intend to deplete the asset through use

If you intend to sell the asset

Fair value measurement (IFRS 13)

Fair value

Examples of IFRSs that require 'fair value' measurement in certain circumstances :

- IFRS 5 – Non-Current Assets Held for Sale and Discontinued Operations
- IFRS 15 – Revenue from Contracts with Customers
- IAS 16 – Property, Plant & Equipment
- IAS 19 – Employee Benefits
- IAS 36 – Impairment of Assets
- IAS 38 – Intangible Assets
- IAS 40 – Investment Property

Examples of standards that require fair value measurement by reference to another standard:

- IAS 2 – Inventories
- IFRS 7 – Financial Instruments: Disclosures
- IAS 21 – The Effects of Changes in Foreign Exchange Rates
- IAS 28 – Investments in Associates and Joint Ventures

Fair value

Prior to IFRS 13, guidance on measurement & disclosure of 'fair value' scattered across various IFRSs and:

- Not always consistent between IFRSs
- Incomplete as it did not provide a clear measurement objective nor a robust measurement framework

Not having a single set of guidance for 'fair value' measurement and disclosure:

- Added unnecessary complexity to the IFRSs and
- Contributed to diversity of accounting practice

In May 2011, the IASB issued a single, standard (IFRS 13) which consolidates and provides guidance on 'fair value' measurement and disclosure.

Key Definitions

'Active market':

a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis

'Entry price':

an estimate of the price that you would pay to buy an asset or receive to assume a liability

It is the price that would be paid when the asset/liability is *entering* the entity i.e. being purchased.

Key Definitions

'Exit price':

an estimate of the price that would be received to sell an asset or paid to transfer a liability.

It is not the price to buy the asset or incur the liability (i.e. entry price)

It is the price that would be received when the asset/liability is *exiting* the entity – i.e. being sold.

'Fair value':

the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Frequently referred to as an "exit price"

Fair Value Hierarchy

IFRS 13 seeks to increase consistency and comparability in fair value measurements and disclosures through a fair value hierarchy

The hierarchy categorises the inputs used in the entity's valuation techniques into three levels

The hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities

The hierarchy gives the lowest priority to unobservable inputs

3 levels of FV hierarchy

1. Level 1 inputs

Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date

A quoted market price in an active market provides the most reliable evidence of fair value

It is used without adjustment to measure fair value whenever available, with limited exceptions

2. Level 2 inputs

Observable inputs other than quoted prices for identical assets or liabilities in an active market at measurement date

3 levels of FV hierarchy

3. Level 3 inputs

Unobservable inputs e.g. inputs derived through extrapolation or interpolation that cannot be corroborated by observable data

The fair value measurement objective remains the same for unobservable inputs, therefore unobservable inputs should:

- Be adjusted for entity-specific information that is inconsistent with market expectations.
- Consider the risk premium a market participant (buyer) would demand to assume the inherent uncertainty in the unobservable input

Impairment of assets (IAS 36)

Impairment of assets

Objective:

set out procedures to ensure asset carried at no more than its recoverable amount

Definitions

Impairment loss

amount by which CA exceeds recoverable amount

Carrying amount

amount which asset is recognised (on balance sheet) after accumulated depreciation & accumulated impairment losses

Recoverable amount

higher of:

(i) "Fair value" – costs to sell

(ii) Value in use [present value of future cash flows from asset]

Background

Impairment is sudden dilution in value of an asset over & above normal wear & tear

Reduction of recoverable amount of asset below its carrying amount

Why does impairment occur? Something happens to asset or in econmic environment which asset operates

How do you measure impairment?

- Recoverable amount versus Carrying amount
- Recoverable amount = higher of fair value (less costs) & value in use
- Carrying amount = cost – accumulated depreciation – accumulated impairment
- If CA > RA write asset down to recoverable amount
- If CA < RA no impairment

Indicators of impairment

External:

- Significant decline in assets market value as result of passage of time or use (in excess of norm)
- Significant Δ (with adverse effects for company) in technological market, economic or legal environment in which company operates
- Increase market interest or other rate which increases discount rate for calculating 'value in use'

Internal:

- Obsolescence or physical damage of an asset
- Significant Δ in way asset used or expected to be used e.g. assets become idle, plan to discontinue or restructure an operation
- Evidence that economic performance of the asset has been worse than expected

Example

Company X has a factory which produces Tamagotchis

Factory reflected on balance sheet:

- Cost €1,000,000
- Accumulated depreciation €500,000

The company does some research on the value of the factory:

Value in use: €300,000

Fair value: €520,000

Costs to sell: €30,000

Apply IAS 36 impairment mechanism to the info above.
Should an impairment be recognised?
Can you provide the journal?

Answer

Answer - Journal

Investments / non-current assets

- Productive capacity

Property, plant & equipment (IAS 16)

Definitions

- Depreciable amount = cost – residual value

- Depreciation = systematic allocation of depreciable amount is assets useful life

- Entity specific value = present value of cash flows from use of asset and disposal value

- Useful life = period during which asset expected to be available for use & number of units of production expected to be obtained from asset

Recognition

Recognise an item of PPE on the balance sheet when:

- Probably future economic benefits will flow to entity
- Cost can be measured reliably

Initial measurement

At **cost** – which includes:

- Purchase price including import duties & non-refundable taxes
- Costs of bringing item to conditions and location necessary for use e.g. site costs, delivery costs, costs of testing if functioning, professional fees etc.
- Initial estimate of cost of dismantling item & restoring site
- Borrowing costs under IAS23

But must expense day to day servicing !

If expenditure to maintain capacity → expense

If expenditure to enhance capacity → capitalize

Subsequent measurement

Choose between:

1. Cost model or
2. Revaluation model

Cost model:

- Cost – acc depreciation – acc impairment

Revaluation model:

- Fair value at date of revaluation – acc depn – acc impairment

Revaluation

Revaluation model allows companies to mark the value of their PPE to fair value

If the carrying amount is marked up, the increase is an unrealised gain (paper gain) until the building is actually sold

If the gain were allowed in the income statement → companies would have a mechanism to alter profit with paper gains

This is not permitted → the gain must be captured in an equity account called “Revaluation Reserve”

If the value of the PPE decreases in future → impairment must first eliminate this reserve before being expensed

Example

Company acquired a building in 2015 at a cost of €100,000. The useful life of the building was 50 years & its residual value was nil. Depreciation is provided on a straight-line basis.

At 1 January, 2020 the building was revalued to €135,000 and remaining useful life remained unchanged at 45 years.

Show how this would be recorded in the company's books.

Example

Loss on Revaluation

A revaluation loss should be charged against any related revaluation surplus

Any additional loss must be charged as an expense in the income statement.

What if the previously revalued building is valued at 1 January 2021 at €70,000 ?

Loss on Revaluation

Loss on Revaluation

Intangible assets (IAS 38)

Criticism of accounting for R&D & Intangible assets

Current accounting rules fail to capture intangible assets well:

- https://podcasts.apple.com/gb/podcast/john-collison-growing-the-internet-economy/id1154105909?i=1000478171547
- Listen to John Collison – Co-Founder Stripe – 52:00 – 1:01:53
- Criticises accounting for R&D and intangible assets

Definitions

Intangible asset: an intangible

- non-monetary asset
- without physical substance
- capable of being separated from entity and sold

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

Development: Application of research findings or other knowledge for the production of new or substantially improved materials, devices, products etc. prior to the start of commercial production or use

Must meet “asset” definition

It must meet the Conceptual Framework definition of an asset:

An asset is a present economic resource controlled by the entity as a result of past events

- An economic resource is a right that has the potential to produce economic benefits

Why is this a problem?

Recognition

2 conditions for recognition:

(1) When it is probable that future economic benefits attributable to the asset will flow to the entity

- i.e. revenue from sale of goods & services / cost savings

(2) Cost of asset can be measured reliably

Initial measurement

Initially recorded at cost:

- Purchase price + import duties + non-refundable taxes
- - trade discounts & rebates
- + directly attributable costs of preparing the assets for its intended use e.g. professional fees, testing whether asset is functioning properly, etc.

Subsequent measurement

Choose between:

1. Cost model or
2. Revaluation model

Goodwill

Internally generated goodwill:

Do not recognize internally generated good will as an asset because it is not deemed to be an identifiable resource i.e. it cannot be separated.

Purchased goodwill:

Accounting treatment detailed under IFRS3 Business Combinations.

Research

Accounting treatment:

Do NOT recognize cost of research as an asset.

Write off as an expense in year occurred

Justification:

There is no reasonable certainty that future economic benefits will flow to the entity from the research.

Examples all relate to searching for information or knowledge can see nothing concrete (future economic benefits) with these activities.

Development

Accounting treatment:

Expenditure on development should be capitalized if all 5 conditions are met.

Conditions:

I. Technical feasibility of completing the intangible asset

II. Intention by entity to complete the asset and use or sell it

III. Ability of entity to use or sell the asset

IV. The likelihood of the asset generating probable future economic benefits e.g. existence of a market for the output of an asset.

V. Ability to measure the expenditure attributable to the asset.

Justification:

Unlike research, development costs are incurred much later on in the project therefore more appropriate to have reasonable certainty as to probable future economic benefits

Development examples

Design, construction, testing of pre-production & pre-use prototypes and models

Design of tools, jogs and dies involving new technology

Design, construction and operation of pilot plant that is not of a scale economically feasible for commercial production

Design, construction and testing of a chosen alternative for new or improved materials, devices, processes, systems or services

Leases (IFRS 16)

Introduction

Under the previous standard for leases, IAS 17, companies which classified leases as operating leases (or 'off balance sheet' leases) did not record a liability (debt) in the balance sheet for future lease payment obligations

- For example, aeroplanes for major European airlines did not appear as assets on their balance sheets
- In substance, the airlines had not purchased the aeroplanes but had committed to significant future lease obligations with the leasing companies, in exchange for extended use of the assets (the aircraft)

A new accounting standard for leases, IFRS 16, was issued by the IASB in January 2016

Introduction

IFRS 16 outlines principles for the recognition, measurement, presentation and disclosure of leases for both parties to a lease contract

- i.e. the lessee (the customer) and the lessor (the supplier).

IFRS 16 is applies to annual reporting periods beginning on or after 1 January 2019.

The requirements of IFRS 16 represent a significant change in approach to accounting for leases for lessees

Lessees are required to recognise most leases on their balance sheets and to measure the leases using a single lessee accounting model

Lessor accounting is substantially unchanged under IFRS 16.

Key IFRS 16 Principles

Lessees:

There are substantial changes for lease accounting for lessees under IFRS 16, when compared to IAS 17:

Lease recognition:

IFRS 16 eliminates the classification of leases as either operating or financing leases.

Under IFRS 16, all leases result from a lessee obtaining:

A right to use an asset (i.e. right-of-use asset) at the start of the lease and

Financing – if lease payments are made over time.

Key IFRS 16 Principles

Therefore, IFRS 16 requires lessees to recognise for *all* leases:

On the balance sheet:

- A right-of-use asset &
- A lease liability

On the income statement – required to disclose separately:

- Depreciation on the right-of-use asset &
- Interest on the lease liability

LESSEES

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LESSEES: Accounting by lessees

Upon commencement of the lease, a lessee is required to recognise:

- The right to use the underlying asset (i.e. a right-of-use asset) for the lease term &
- A lease liability for the obligation to make lease payments.

Fundamentally different way to think about a lease: Think about leasing a car from the airport

We will look at the measurement requirements for each of the above in turn:

- 'Right-of-use' asset
- Lease liability

Accounting for 'right-of-use' asset

Initial measurement:

Amount of the lease liability plus any initial direct costs incurred by the lessee.

Subsequent measurement:

'right-of-use asset' measured using the *cost model* under IAS 16 (Property, Plant and Equipment)

Under IAS 16's cost model:

The 'right-of-use asset' is measured at cost *less* accumulated depreciation *less* impairment [in accordance with IAS 36 (Impairment of Assets)]

Accounting for 'lease liability'

Initial measurement:

The lease liability should be measured at the present value of the lease payments payable over the lease term.

The lease payments should be discounted at the interest rate implicit in the lease

- If implicit rate not available → use incremental borrowing rate

Re-measurement:

The lease liability should subsequently be remeasured to reflect changes in:

- The lease term (using a revised discount rate)
- The assessment of a purchase option (using a revised discount rate)
- The amounts expected to be payable under residual value guarantees (using an unchanged discount rate) or
- Future lease payments resulting from a change in an index or a rate used to determine those payments (using an unchanged discount rate).

Example

- X Ltd enters into a lease contract with AFinance Ltd for the lease of a large motor grader.
- The lease term is 5 years.
- Under the terms of the lease, X Ltd pays an annual lease payment of €50,000 for lease of the grader.
- AFinance Ltd charges its clients 6% interest per annum for the provision of credit facilities.
- X Ltd pays an additional €10,000 to have special treads installed on the motor grader.
- X Ltd's policy is to depreciate plant and machinery on a straight line basis over 5 years.

Question:

How should X Ltd (the lessee) account for the above transaction under IFRS 16 (Leases)?

LESSEES: Accounting by lessees

	0	1	2	3	4	5
Lease payments						
Cash Flows						
Discount Factor		$\frac{1}{(1+0.06)^1}$	$\frac{1}{(1+0.06)^2}$	$\frac{1}{(1+0.06)^3}$	$\frac{1}{(1+0.06)^4}$	$\frac{1}{(1+0.06)^5}$
Discount Factor		0.94	0.89	0.84	0.79	0.75
Discounted Cash Flow						
Net present value						

LESSEES: Accounting by lessees

Year	(1) Opening capital balance (SOFP)	(2) Lease Payment	(3) Interest/Finance Expense (P&L) (1) x implicit interest rate	(4) Difference: to capital sum (2) - (3)	(5) Closing capital balance (SOFP) (1) - (4)
0					
1					
2					
3					
4					
5					

** Rounding difference due to rounding off discount factors used in present value calculation to 2 decimal places.*

LESSEES: Accounting by lessees

LESSEES: Accounting by lessees

LESSEES: Accounting by lessees

INCOME STATEMENT FOR YEAR 1

BALANCE SHEET AT END OF YEAR 1

Non-current assets

Non-current liabilities

Current liabilities

Operating items

Inventory (IAS 2)

Definition

Inventories are assets:

o Held for sale in the ordinary course of business;

o In the process of production for such sale; or

o In the form of materials or supplies to be consumed in the production process or in the rendering of services

Initial recognition

Inventories can be recognised at cost including:

- Cost of purchase
- Cost of conversion
- All other costs required to bring the inventories to a condition to be ready for sale

Cost of purchase

Purchase price (including import duties & non-refundable VAT)

+ costs attributable to acquisition of inventory (transport and handling costs)

- trade, cash, settlement discounts

Cost of conversion

Include:

- Materials
- Direct labour costs
- Allocation of fixed and variable production overhead costs
- Borrowing costs capitalised under IAS23

NEVER include:

- **Admin or other overheads not directly attributable to bringing item to present condition or location**
- **Storage costs, unless necessary stage of production process**
- **Abnormal amounts of wasted materials, labour or other production costs**
- **Selling costs**

* above would be expensed, except abnormal wastage which would form part of a Cost of Sales

Subsequent measurement

Value inventories at lower of:

- Cost &
- Net Realisable Value (NRV).

NRV is the estimated selling price, less estimated completion costs and the estimated selling costs

Provisions, contingent liabilities & contingent assets (IAS 37)

Provisions

Provisions can be used to smooth earnings & EPS:

- If results are very good for a year can decrease provisions & release income in future years (when income perhaps is not as high)
- In general, economic downturn companies can stash away provisions because investors judge bad performance less harshly

To address potential misuse standard sets out recognition criteria & measurement base

Provision vs liability

Difference between provision and other liabilities:

- Provision - liability if uncertain timing or amount
- Key – existence of UNCERTAINTY

Provision vs accrual

Accounted for in much the same way

But provisions have greater disclosure requirements

Key difference = level of uncertainty

Accrual arises where company received goods or services without paying for them

- i.e. EDF – you know you've used electricity for a month
- But haven't received invoice so don't know actual price
- Relatively low level of uncertainty about price
- Does not warrant a provision

Provision vs contra accounts

IAS37 does not apply to contra accounts i.e.

- Accumulated depreciation
- Allowance for doubtful debt (even called “provision” for doubtful debt)

Contra accounts:

- Are associated with a specific account & reflect a write down or reduction
- While maintaining the original value of an asset account (i.e. PPE cost, Accounts Receivable)

Recognition of provision

A provision should be recognized when:

1. Reporting entity has a present obligation (legal or constructive) as a result of a past event

2. Probable outflow of resources embodying economic benefits will be required to settle obligation

3. A reliable estimate of amount can be made

Contingent liability

Must exist be as a result of past event

But fails one of the 3 tests for a provision

Is only disclosed in the Notes to the financial statements

- Another reason why Notes are such an important source of info

Contingent asset

A contingent asset is:

- possible asset
- arises from past event
- existence will be confirmed by occurrence / nonoccurrence of one or more uncertain future events not wholly in control of the entity

Never recognized in the financial statements!

Only disclosed when economic inflow is probable !

Measurement of provision

Use best estimate of expenditure required to settle present obligation at balance sheet date [considerable amount of judgement required]

Should be measured at present value where time value of money will have a material effect

Changes in provision:

- Provision should be reviewed at each balance sheet date & adjusted to reflect latest best estimate
- If provision no longer necessary → reverse immediately

Other issues

Can’t borrow from provisions for any reason other than the reason it was established

Provision may **NOT** be recognized for future operating losses

Proposed div.; no prov.. Recogn. Fr divs proposed before y/e but only approved by shares after y/e. Obligating event NOT div being proposed but approved by shareholders.

IAS1 requires these unrecognized div. to be disclosed in notes

Onerous contract

Onerous contract: a contract where you will make a loss

IAS37: create provision for loss immediately !

2 effects on financial statements:

1. Provision for loss under contract
2. If Inventory subject of contract

- Contract price is the Net Realisable Value
- IAS 2: inventory must be measured at lower of cost & NRV
- Therefore: may have to write inventory (subject to contract only) down to its net realizable value (the contract price)

Question for class #1

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You open up a pop-up burger restaurant out of the back of a van

Your business is very profitable & you grow to 15 vans quickly

You sell an undercooked burger which makes a customer sick on 15th July 2020

The customer sues you for €1,000,000 from 15th July 2020

The financial reporting date for your company is 31 December 2020

The court case is still ongoing at 31st December (judge has not yet ruled)

Your corporate law firm tells you it is highly probable you will lose the case early next year & have to pay the full sum (€1m) based on outcomes of similar cases

Should your accountant recognise a provision on 31 December 2020 ?

Question for class #2

The directors of company X declare a dividend on 15th December 2020 of €1.50 per share (total dividend €250 million)

The company's financial reporting year end is 31st December 2020

The dividends have not been paid to shareholders by 31st December 2020

The annual meeting of the company is on 30th April 2021

Should your accountant recognise the dividends as a provision on 31 December 2020 ?

Operating items

Cash

- Very important !
- Discuss in Session 4

Financing items

- Equity

Financing items - Equity

Understanding the equity accounts

Equity

There are 2 types of ownership interest:

1. Capital contributed by owners

- "Share capital", "Paid in capital" – based on par value
- "Share premium"
- What is the difference between share capital & share premium accounts?

2. Arising from sale of goods & services or the payment of dividends

- "Retained earnings", "Retained profit"
- What does Retained Profit represent?

Financing items - Equity

The statement of changes in equity

Statement of changes in equity

Owners are concerned with how their interest has changed

Balance sheet gives limited info in Equity section

SOCIE provides a reconciliation of major movements in all equity accounts during year

- See the SOCIE on IAS 1 template financial statements

Where would you find dividends paid?

- Would you find it on an income statement ?

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