International Financial Accounting

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About

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Background

Learning plan

Session 1 – Introduction & context

Session 2 – Balance sheet

Session 3 – Income statement

Session 4 – Cash flow statement

Session 5 – Notes to the financial statements

Session 1

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Introduction & context

Session 1: Context

Why learn international accounting rules?

Group project info

International Accounting Standards Board (IASB)

The Conceptual Framework

Presentation of Financial Statements (IAS 1)

Group accounting – core concepts

Why learn international accounting?

Why learn international accounting?

International accounting rules adopted in over 120 countries around the world

- Some of the largest companies in the world are using these rules to prepare their financial statements

Accounting is how businesses signal their financial position & performance to the market

- A knowledge of accounting helps you to interpret these signals

Accounting data underpins many finance techniques & processes

- Knowing how the figures were constructed allows you to apply the data in a more meaningful way

CFA

Screening questions

Session Goals

In these sessions, my goal is deepen your knowledge of financial statements (& accounting data)

- Improve your ability to interpret financial statements
- Understand the accounting data you inevitably will work with in future
- Learn how the figures are constructed from an accountant's perspective
- Tailored module to be relevant to finance professionals – rather than accountants
- Be able to hold a conversation with an accountant at the office watercooler!

Group project

Group Project

Groups (of 2) & group project available on Campus

You have until **Friday 15th October 2021 by 17:00** to submit project on Campus

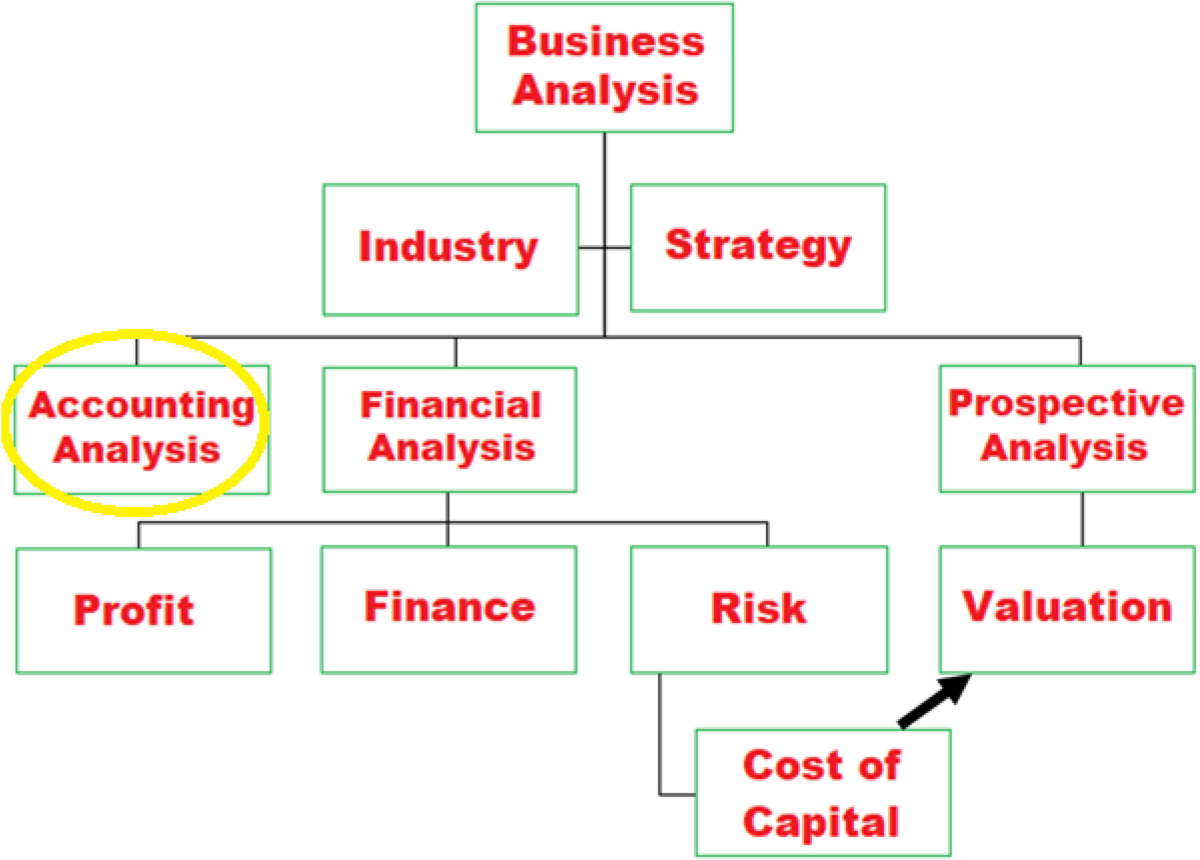
Max 6 pages report (excluding title & index pages)

Select 2 companies in same industry ; not financial services

Perform a basic accounting analysis:

- Show knowledge of accounting rules
- Compare & contrast the details of their accounting policies
- Consider how the policies impact on the financial statements & evaluation of the companies

Business analysis



Accounting analysis

Accounting policies & estimates

How well is the company capturing the reality of its business transactions & events?

What level of distortion is there within the accounts?

Review the Notes to the financial statements

- i.e. Note 1 – Accounting Policies

Factors Influencing Accounting Quality

- Despite the existence of accounting regulation (numerous accounting standards) & external audit there will be an element of bias in the accounts

- Noise and Bias
  – Forecast error
  – Reporting choices by corporate manager
  – Rigidity in accounting rules

Accounting Choices - Motives

- Managers may have a variety of incentives to exercise their accounting discretion to achieve certain objectives:
  - Accounting based debt covenants
  - Management compensation
  - Corporate control contests
  - Tax
  - Regulatory considerations
  - Capital market considerations

Financial Shenanigans

- Discovery is unlikely
  - Penalties small
  - Accounting rules can be broad/subjective
  - Internal controls may be weak

- Most prone
  - High growth companies
  - Weak companies
  - Private companies
  - Newly public companies

- Recent example: Wirecard
  https://www.wsj.com/articles/how-germanys-sec-dismissed-a-decade-of-warnings-about-wirecard-11594907212

Accounting Analysis Steps

Identify potential **red flags** –

- Unexplained changes
- Unusual increases
- Unexpected large asset write offs
- 4th quarter adjustments (Aggressive management)
- Qualified audit opinion/ changes in auditors
- Related party transactions

Use red flags to probe further - not as an end point in itself

Techniques to Distort

1. Choice of accounting treatment permitted under IFRS

- Depreciation calculation
- Revenue recognition policy
- Cost versus Fair Value measurement

2. Timing the adoption of a new accounting standard

- Adjusting through income statement or retrospective adjustment to balance sheet equity
- Decision not to implement a new standard on grounds of materiality

Techniques to Distort

3. Judgement calls: depreciation, allowance for bad debts, asset valuation, impairments

4. Classificatory management

- Classifying items between Profit & Loss or Other Comprehensive Income

Techniques to Distort

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5. Structuring transactions to achieve desired accounting outcome
   - Timing sales of assets during period where tax carry back / forward rules apply
   - Altering legal form in an attempt to manipulate accounting treatment (US bank & loan book)

6. Managing the transparency of the information

7. Real production & investment decisions i.e. cutting back on research & development expenditure

International Accounting Standards Board (IASB)

Why standardise accounting regulation?

The world's two main standard setting bodies are:

- United States - Financial Accounting Standards Board (FASB)
- International – International Accounting Standards Board (IASB)

The IASB's accounting rules are International Reporting Standards (IFRS)

- IFRS has been adopted by over 120 countries around the world

The FASB's accounting rules are Generally Accepted Accounting Principles (US GAAP)

- US GAAP is applied within the United States
- The United States contains some of the world's largest capital markets
- The non-adoption of IFRS by the US is a major limitation to the global adoption of IFRS

Why standardise accounting regulation?

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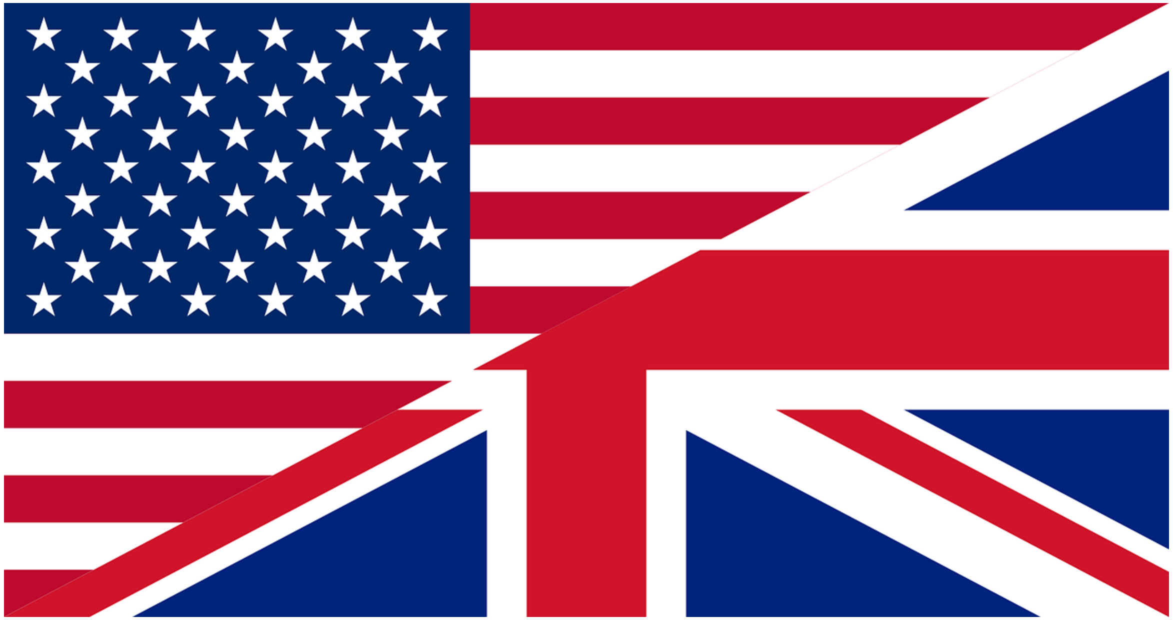
The Rise of Accounting & Accounting Regulation

The FASB and IASB have worked to converge their accounting regimes into a single, high quality set of accounting standards

But what are the benefits to standardisation?

1. It aids international investment
2. It helps multinational companies cross-list in multiple countries
3. It helps professional accountants and auditors to become internationally mobile

Brief history of standard setting bodies



The United States

The histories of the world's major standard setting bodies: The United States

The US was the first country to take significant steps towards codification and mandatory application of accounting rules (regulation)

In the 1920s, researchers empirically examined accounting methods and doctrines being applied by accountants

- They described conventions/doctrines such as conservatism, materiality, consistency, the entity assumption and matching principle

This work was important in 1929 when the US stock market crashed

The histories of the world's major standard setting bodies: The United States

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The stock market crash of 1929 was the impetus for accounting regulation

- NYSE requested accounting profession to compile list of broadly used accounting principles

Securities legislation passed in 1933 and 1934

- Led to creation of US Securities and Exchange Commission (SEC)
- Securities Exchange Act, 1934, requires disclosure of stipulated information by companies seeking to trade their securities
- The SEC is provided the authority to develop accounting regulation
- The SEC delegates this authority to the accounting profession
- Accounting profession publishes: *A Statement of Accounting Principles*

From Wild West to mandatory regulation:

Finally, in 1973, the SEC delegates the task of developing accounting standards to the Financial Accounting Standards Board (FASB)

- The FASB established as a private body acting in the public interest
- But not entirely independent: SEC can over-rule the decisions of the FASB

The United Kingdom (and internationally)

The United Kingdom comparatively slow to introduce codified accounting regulation

It was only in the 1970s that the Accounting Standards Steering Committee was established

- This body would later become the IASC and then the IASB

Environment in 1960s and 1970s allowed for the creation of an international accountancy body:

- 1960s increasing number of mergers and acquisitions of European companies by American companies
- The UK committed to joining the European Economic Community in 1972

In the context of this environment:

- Henry Benson elected Chairman of ICAEW
- Benson would be a key figure in the creation of international accounting regulation
- Benson established closer relations with professional accountancy bodies in the United States and Canada to:
  - Advance the interests of the profession as a whole
  - Establish a common approach to accounting & auditing problems

The histories of the world's major standard setting bodies: The United Kingdom

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February 1967: the three bodies (UK, US and Canada) jointly formed the Accountants' International Study Group

- Group publishes papers on accounting topics & develops its own doctrinal framework
- Becomes the basis for the creation of the International Accounting Standards Committee (IASC) in 1973

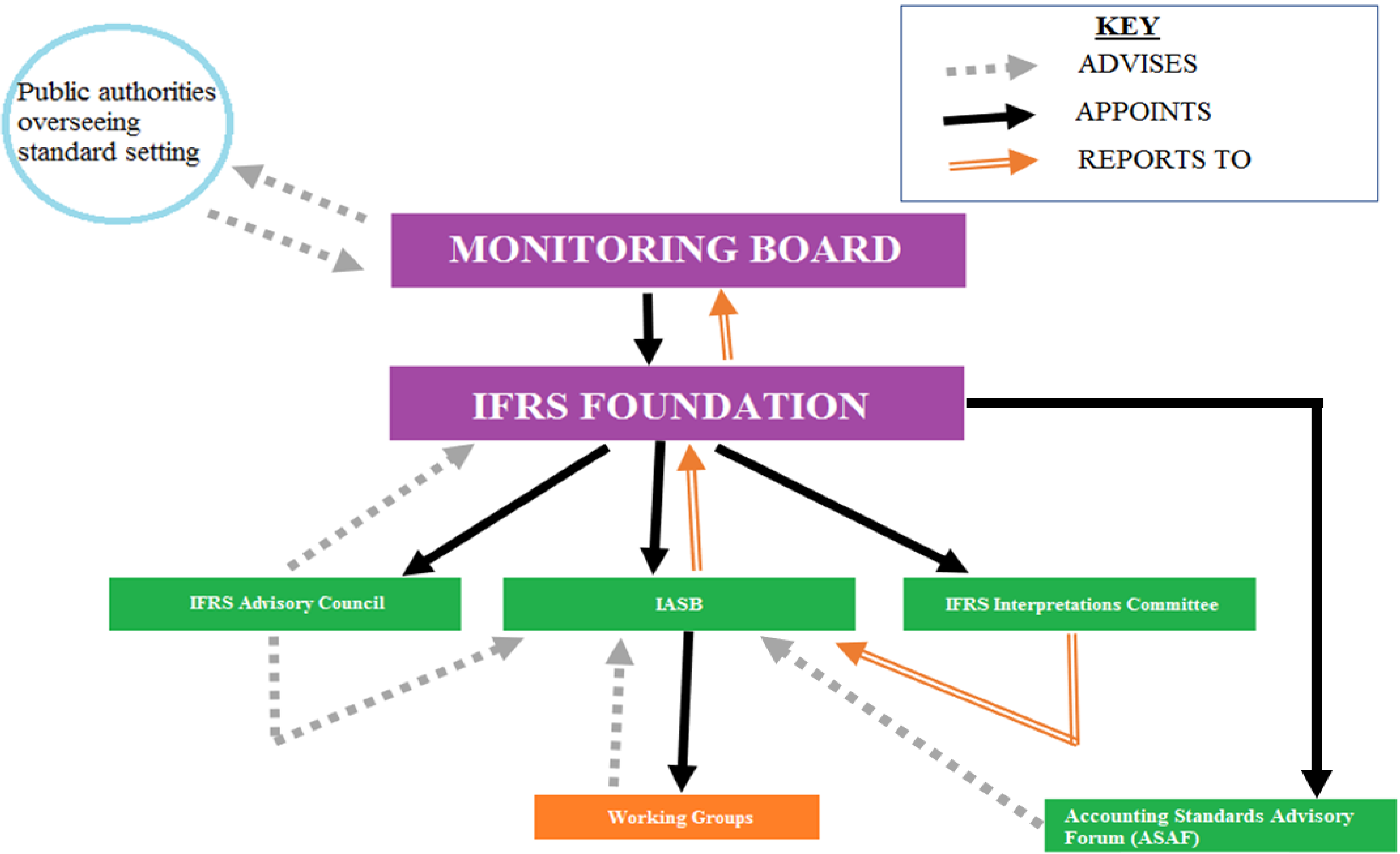
The histories of the world's major standard setting bodies: The United Kingdom

In 2001, the IASC restructures and becomes the International Accounting Standards Board (IASB)

- The new structure considered to make body more independent and rigorous
- IASB adopts all of the existing IASs issued by the IASC
  - In the future, it will publish new regulations in the form of International Financial Reporting Standards (IFRS)

- The policy of the IASB shifts from convergence to standardisation:
  - The implementation of a single set of high quality, global standards.

The structure of the IASB



The IASB

Comprises of a maximum of 16 members.

IASB members must comprise a group of people representing the best combination of technical skills and background experience of relevant international business and market conditions in order to contribute to the development of high quality, global accounting standards.

To approve an IFRS, 10 out of 16 IASB members must vote in favour of it.

The IASB has the authority to develop accounting standards but it does not have the power to enforce those standards as an independent body.

- This creates an issue: different countries that have adopted IFRS may enforce the requirements of IFRS in a less formal manner.
- Case Study 1.1.1

The structure of the IASB

Case Study 1.1.1: Société Générale (France)

In January 2008, French bank, Société Générale, lost €6.4 billion as part of a fraud.

The bank decided to shift the loss, which occurred in 2008, to the 2007 financial statements and to offset it against a €1.5 billion profit earned by a trader who concealed bets in financial futures markets.

Société Générale justified its accounting practice by invoking the 'true and fair' provision of international accounting standards.

- 'The true and fair' provision allows companies to depart from the accounting rules, in extremely rare circumstances, where management concludes that compliance with the rules would be so misleading that it would conflict with the objective of financial statements**.**

This highlights a number of issues with international accounting standards:

- The IASB is an independent body: it may write the accounting rules but it has no power to enforce them.
- Further, it raises the question: can international accounting standards be consistently applied in countries around the world?

Conceptual Framework

Status & Purpose of CFW

CFW describes the objective of and concepts for financial reporting

The CFW is not a Standard

Nothing in the CFW overrides any Standard or any requirement in a Standard

Objective of general purpose financial reporting

The objective of general purpose financial reporting is:

- to provide financial info about the reporting entity that is useful
- to existing & potential investors, lenders & other creditors
- in making decisions relating to providing resources to the entity

Qualitative characteristics of useful info

Details types of information that would be useful to users to make capital allocation decisions

- Linked to the *objective* of general purpose financial reporting

Divided into 2 categories:

1. Fundamental qualitative characteristics of useful financial info
2. Enhancing qualitative characteristics of useful financial info

Fundamental qualitative characteristics

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1. Relevance
   - Predictive value
   - Confirmatory value
   - Materiality

2. Faithful representation
   - Complete
   - Neutral
     - Prudence
   - Free from error

Enhancing qualitative characteristics

Enhancing qualitative characteristics:

1. Comparability
2. Verifiability
3. Timeliness
4. Understandability

Elements of financial statements

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- Assets - Liabilities - Equity	Financial position
- Income - Expenses	Financial performance

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

Definition of a liability

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A liability is a present obligation of the entity to transfer an economic resource as a result of past events

Quiz

An up and coming golf brand signs a contract with a popular professional golfer, Simba Forest, to wear their brand during an upcoming tour

How would the accountant of the brand think about this contract?

Answer

Definition of equity

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Equity is the residual interest in the assets of the entity after deducting all of its liabilities

Definition of income and expenses

Income:

- Income is increases in assets, or decreases in liabilities
- that result in increases in equity
- other than those relating to contributions from holders of equity claims

Expenses:

- Expenses are decreases in assets, or increases in liabilities
- that result in decreases in equity
- other than those relating to distributions to holders of equity claims

Presentation of financial statements (IAS 1)

IAS 1

IAS 1 is different in nature to the other IFRSs:

- IAS 1 outlines the broad structure of the financial statements
- Other IFRSs fill in the detail within the financial statements: the recognition, measurement & disclosure requirements

IAS 1 takes priority over the IASB's *Conceptual Framework for Financial Reporting* where any conflict arises

Discussing the presentation requirements of IAS 1 can be abstract

There are IAS 1 templates for the presentation of the balance sheet, income statement and statement of changes in equity in the notes

These templates can be an effective way to review the structure and presentation requirements of IAS 1

The financial statements

A *complete* set of financial statements comprises of:

1. Statement of financial position at the end of the reporting period
2. Statement of profit or loss and other comprehensive income for the period.
3. Statement of changes in equity for the period
4. Statement of cash flows for the period
5. Notes to the financial statements – comprising of significant accounting policies and other explanatory information

Balance sheet

IAS 1 does not prescribe any particular balance sheet format or structure.

- For example, it is acceptable for entities to apply either the horizontal or vertical formats of balance sheets.

The standard prescribes minimum requirements for separate line items on the balance sheet

- Accountants allowed flexibility to provide additional line items, headings and sub-headings

Balance sheet

Current asset: an asset should be classified as current if *any* of the following criteria are met:

1. The entity expects to realise the asset, or intends to sell or consume the asset, in its ordinary operating cycle.
2. The entity holds the asset primarily for the purpose of trade.
3. The entity expects to realise the asset within 12 months of the balance sheet date.
4. The asset is cash or cash equivalents.

Non-current asset: an asset should be classified as non-current if it fails to meet the criteria for a current asset.

Balance sheet

Current liability: A liability should be classified as current if *any* of the following criteria are met:

1. The liability is expected to be settled in the entity's normal operating cycle.
2. The liability is held primarily for the purpose of being traded.
3. The liability is due to be settled within 12 months after the balance sheet date.
4. The entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

Non-current liability: A liability should be classified as non-current if it fails to meet the criteria for a current liability.

Understanding sections (components) of income statement

Analysts and investors frequently rely on income statement information to evaluate the performance of firms and to make investment decisions.

There are a number of IFRS requirements that regulate how accountants should prepare and present income statement information.

Two examples of accounting standards that guide the preparation of the income statement are IAS 1 and IAS 33 (Earnings Per Share)

Income statement

The IASB requires the income statement to capture all-inclusive, total comprehensive income

This means there are distinct parts **of the income statement:**

Parts of income statement:	Characteristics:
Profit or loss (P&L)	*Realised gains or losses ; recurring in nature*
+	
Other Comprehensive Income (OCI)	*Unrealised gains or losses ; typically non-recurring*
=	
Total Comprehensive Income	

Income statement

There are two opposing views on the relative superiority of P&L and total comprehensive income as metrics of firm performance.

- Some believe ***total comprehensive income*** is the superior metric of firm performance
- Others believe the ***profit or loss*** **(P&L)**, because it represents realised gains and losses which are typically recurring in nature, is the superior metric

These opposing views impacted on the requirements of IAS 1 for the structure and presentation of the balance sheet

- Option to present a single, combined income statement or separate statements (see next slide)

Income statement

IAS 1 gives preparer the option to present components of the income statement as either:

A single (combined) ‘statement of profit or loss and other comprehensive income’

OR

Two separate statements:

Statement for the profit of loss (P&L) &

Statement for other comprehensive income (OCI)

Line items

The following line items to appear separately on the face of the income statement:

- Revenue
- Finance costs
- Share of profit or loss in an associate or jointed venture (accounted for under the equity method)
- Tax expense
- A single line for the total profit or loss from discontinued operations (under IFRS 5)

Accountants have flexibility to present additional line items, headings and subtotals that are relevant to an understanding of an entity’s financial performance

Totals

In addition to the line items, IAS 1 requires certain totals to be displayed on the face of the income statement:

- Total profit or loss for the period (P&L total)
- Total other comprehensive income for the period (OCI total)
- Total comprehensive income for the period

Totals …cont’d

Total figures must be split on face of income statement between the portion that belongs to equity holders of the parent company & non-controlling interests

For example:

Total profit of loss (P&L) attributable to:

Equity holders of parent

Non-controlling interests

Total comprehensive income attributable to:

Equity holders of parent

Non-controlling interests

Non-controlling interest

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Income statement totals split between:

Equity holders of parent

Non-controlling interests

Balance sheet has an equity account called "Non-controlling interest"

Annual reports of large companies contain 2 sets of financial statements:

Parent company financial statements

Group financial statements

Can you explain the above? Important for analysts to know !

Group accounting

- The impact of acquiring control of another entity on the financial statements

Introduction

- Reporting entities may acquire interests in other entities by investing in their equity (i.e. buying shares in other companies)

- Under IFRS, the information and accounting requirements for these investments depends on the extent to which the reporting entity can influence or control the investee entity.

- The more influence reporting entity can exert over investee entity, the more comprehensive the accounting information required

  - Necessary to address the accounting issues or pitfalls that can arise from companies being separate legal entities i.e. off-balance sheet financing

Parent exercises CONTROL

= **Subsidiary**

What is meant by 'control'?

- IFRS 10 contains a detailed definition of 'control'
- Basic assumption: control where investor hold > 50% of investee's share capital

IFRS 10 & IFRS 3 apply

• Account for this investment using the "**Acquisition Method**":

-100% of the assets & liabilities of the subsidiary &

-100% of the income and expenses

Parent does NOT exercise CONTROL

Larger investments (i.e. associates and joint ventures)

Acquirer exercises "significant influence" but not "control"

Basic assumption: holds ≥ 20% and ≤ 50% of investee's share capital

Account for this investment using the "**Equity Method**":

- Initial investment + the investing group's share of the post-acquisition increase in those companies' net assets;

- Investing group's <u>share</u> of profit after tax is included in consolidated SOCI;

Parent does NOT exercise CONTROL

Minor investments

= "**Simple (or Trade) Investment**"

Basic assumption: investor holds < 20% of investee's share capital

These are dealt with as financial assets in accordance with IFRS 9:

- Dividends received recorded as income in the consolidated income statement

Accounting for interests in other entities

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Accounting treatment depends on the extent of influence or control

	Simple Investment	Associate Interest	Joint Arrangement	Subsidiary Interest
Ownership:	< 20%	20 – 49%	Joint	≥ 50%
Accounting Standard:	IFRS 9	IAS 28	IFRS 11	IFRS 3 / IFRS 10
Accounting Treatment:	At fair value. Separate consolidated financial statements not required.	Equity method	Joint operation – in accordance with relevant IFRSs. Joint venture – equity method.	Consolidation – acquisition method.

Separate financial statements of parent

If a parent company owns a "subsidiary", must prepare:

- Consolidated/group accounts
- Its own, unconsolidated, financial statements

Let's look at accounting for subsidiaries – where the investor entity controls the investee entity

Definition of "group"

A group is defined as a parent company and one or more subsidiaries.

Group accounts are prepared primarily for the shareholders of the parent company.

Group Accounts – Core Principles

Group accounts add:

- 100% of assets, liabilities, income, expenses and equity for each member of the group

But the core objective when preparing group accounts is to include only elements that have **meaning from the perspective of the group**

Therefore must exclude:

- Sales that were not made to external parties
- Unrealised profits (e.g. profits earned on intra-group sales, where the goods have not yet been sold to external parties)
- Intra-group balances (e.g. amounts owed between one member of the group and another)

Group Accounts – Core Principles

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Group accounts will include 100% of the assets, liabilities, income and expenses of subsidiaries.

- But accounts are prepared primarily for the shareholders of the parent company
- If a subsidiary is not wholly owned, the parent company shareholders need to know that some of the subsidiary's net assets are owned by external parties
- These parties are known as non-controlling interests (NCI) ; used to be referred to as *"Minority Interests"*

Overall objective of group accounts is to include all elements (i.e. assets, liabilities etc.) of all members of the group, and:

- to exclude all transactions, unrealised profits and balances that are intra-group
- to note separately the claims of non-controlling interests

IFRS 3: Business Combinations

A business combination takes place when an acquirer obtains control of one or more businesses

There are two sides to this event:

- Payment being made – normally in cash or equity of acquirer
- In exchange: acquirer obtains ownership of assets & responsibility for liabilities of acquired entity

IFRS 3 requires both of these be measured at **FAIR VALUE**

Group example

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Let’s look at the group example

Group example

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Can we just add the 2 balance sheets together?

	RhinoAir	AerLeadus	CONSOLIDATED
ASSETS			
Plant & Machinery	600,000	150,000	
- Cost	1,000,000	200,000	
- Acc Depreciation	-400,000	-50,000	
Investment in Aer Leadus	170,000	0	
Goodwill			
Current Assets	800,000	140,000	
	1,570,000	290,000	
EQUITY & LIABILITIES			
Share Capital	100,000	100,000	
Share Premium	150,000	10,000	
NDR	400,000	0	
Retained Profit	650,000	45,000	
	1,300,000	155,000	
Non-Controlling Interests			
Long Term Loan	270,000	135,000	
	1,570,000	290,000	

Consolidation issue #1

Why can't we just add the parent + subsidiary financial statements together?

Issue:

At acquisition date: the assets & liabilities of the subsidiary are reflected in 3 places!

Solution:

We only want the original measures of the assets & liabilities

We offset the duplicates:

- Investment in subsidiary (in parent's balance sheet)
- At-acquisition equity of subsidiary (in subsidiary's balance sheet)

Consolidation issue #2

When we offset the 2 items, they may not offset exactly

Different measurement bases:

- Investment in subsidiary – what directors were prepared to pay
- Equity of subsidiary at acquisition – measured under accounting rules (book value)

What does the difference represent?

What should we do with the difference?

IFRS 3 - Goodwill

A new asset is created called "Goodwill"

Why did the directors pay more than the identifiable net assets at fair value?

- Synergies?
- Intangible value?

Goodwill accounted for under IFRS 3

- Not depreciated/amortised but tested for impairment annually

IFRS 3 - Goodwill

Criticisms:

- Can sit on balance sheet (& be included in total assets) for long period – not amortized
- What is it? What does the asset reflect?
- Is it a productive asset? Does it reflect future economic benefits?
- **What should analysts do with it?**

Group Structure

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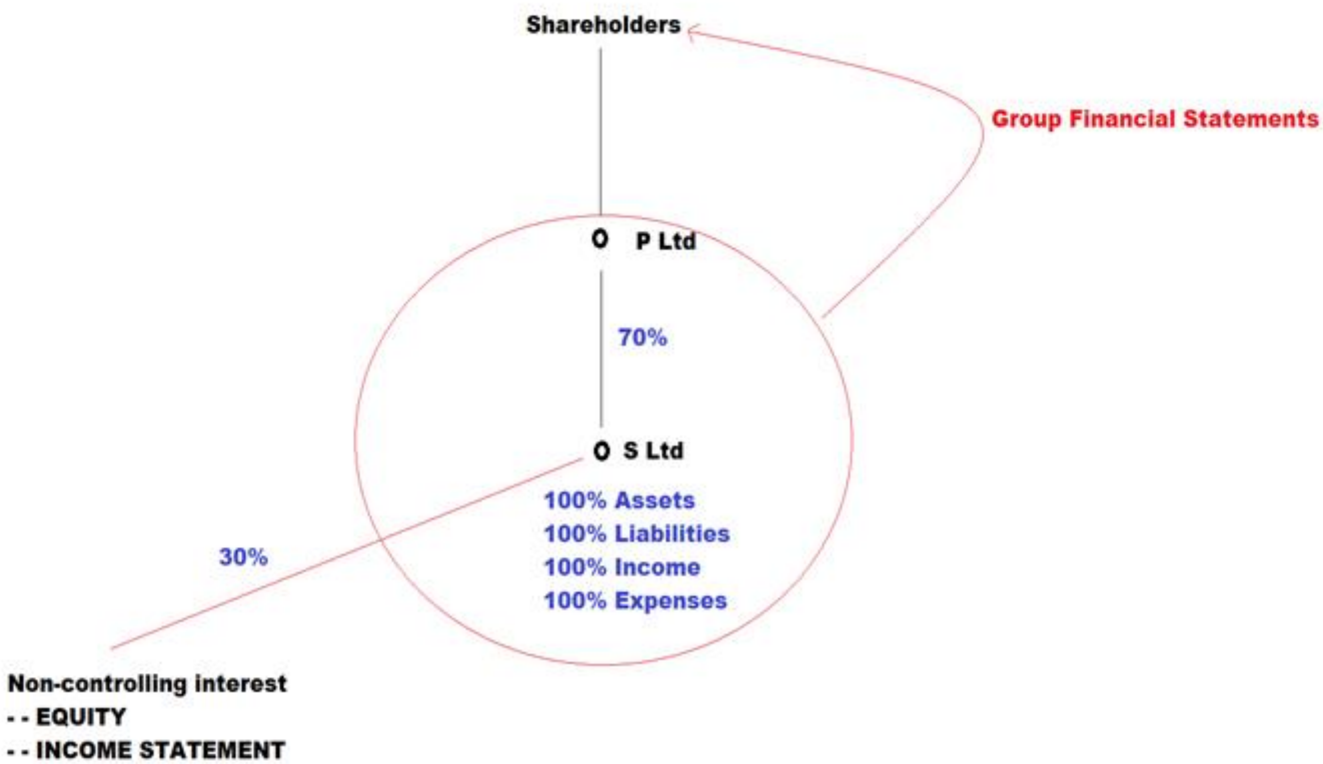
Consolidation rules attempt to address complexities of accounting for groups



Group Balance Sheet

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SUMMARY OF THE CONSOLIDATED SOFP AT ACQUISITION

ASSETS

Non-Current Assets Current Assets	}	Parent company's assets + 100% of subsidiary's assets
Goodwill	}	Created at acquisition date

EQUITY & LIABILITIES

Equity

Share Capital	}	Only parent company's share capital
Equity Reserves	}	Parent's equity + share of subsidiary equity after acquisition
Non-Controlling Interests	}	NCI share of equity

Liabilities

Non-Current Liabilities Current Liabilities	}	Parent's liabilities + 100% of subsidiary's liabilities

Group income statement

SUMMARY OF THE CONSOLIDATED INCOME STATEMENT

Income items	} Parent's income + 100% of subsidiary's post-acquisition income
Expense items	} Parent's expenses + 100% of subsidiary's post-acquisition expenses
Net profit or loss	} Parent's net profit/loss + 100% subsidiary's post-acquisition profit/loss

Attributable to:

Equity holders of Parent company	} Share of net profit or loss belonging to Parent company shareholders
Non-controlling interest	} Share of net profit or loss belonging to NCI

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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

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Investments = Sources of finance

Assets = Equity + Liabilities

Can rearrange this:

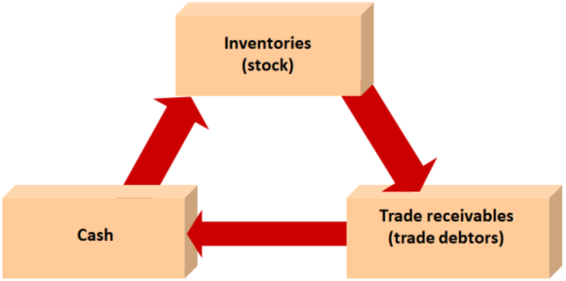
- Equity = Assets - Liabilities

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

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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

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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

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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 <u>not</u> 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

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'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

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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

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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

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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

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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

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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

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

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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

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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

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

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

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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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International Financial Accounting

Dr Sean Power, ACA

Session 3

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Income statement

Session 3: Income statement

Introduction to income statement

Revenue (IFRS 15)

Share-based payments (IFRS 2)

Introduction to income statement

Recap: English terminology

The Income Statement

Revenues

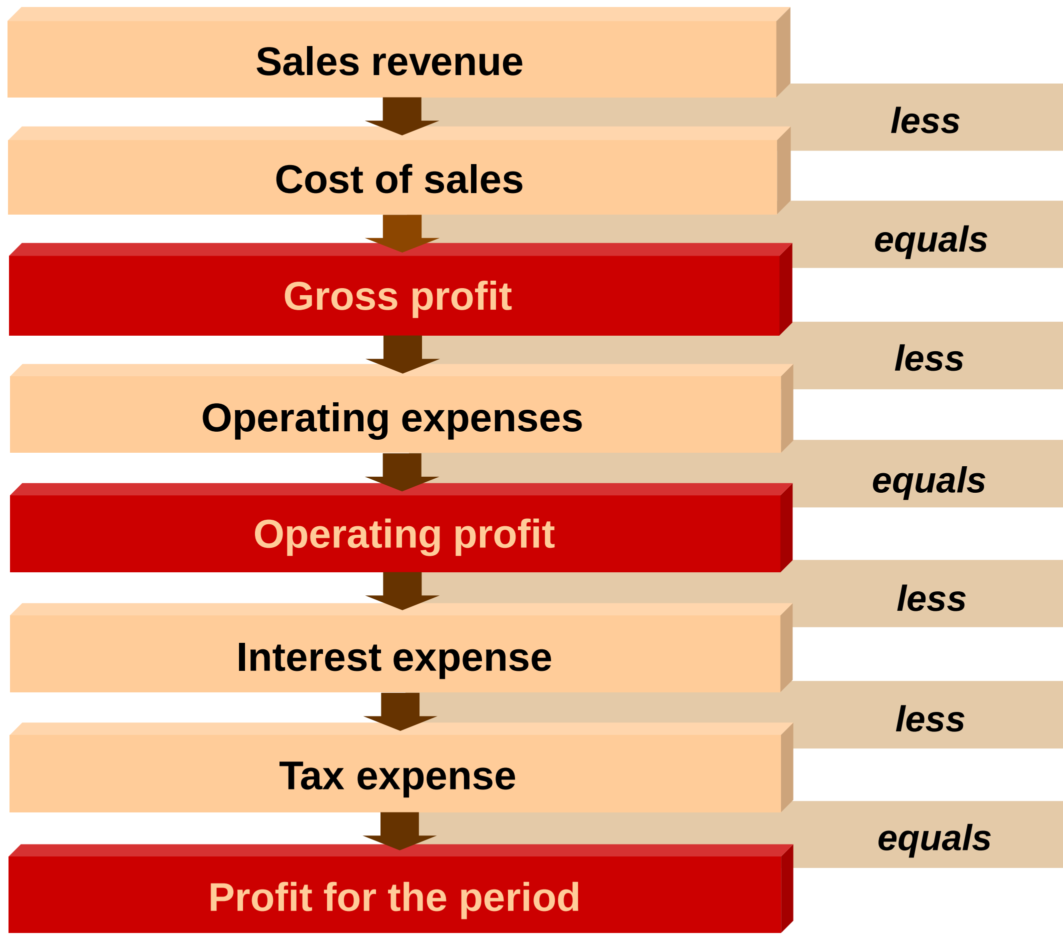
- Sales Revenue
- Fee Revenue
- Interest Revenue
- Rent Revenue

Expenses

- Cost of Goods Sold
- Wages Expense
- Rent Expense
- Interest Expense
- Depreciation Expense
- Advertising Expense
- Insurance Expense
- Repair Expense
- Income Tax Expense

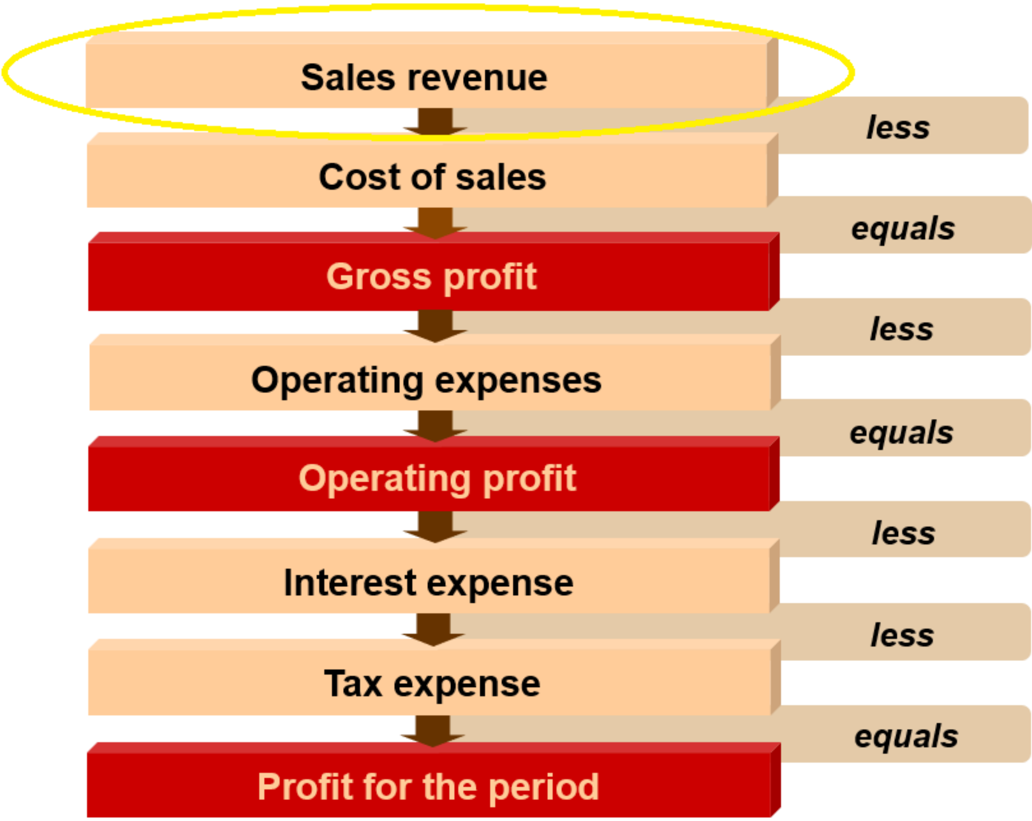
AutoDesk & Ayden

Layout of income statement



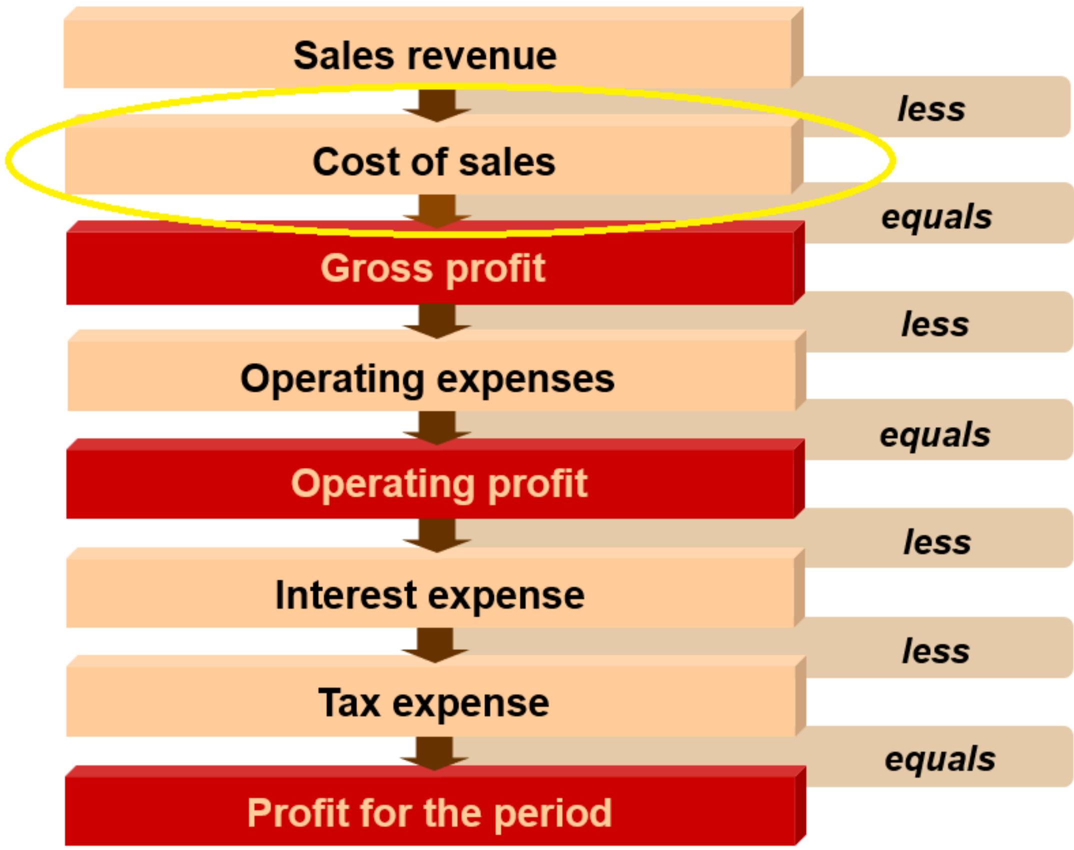
Revenue

(the very important 1st line of income statement)



Cost of sales

(2nd line of the income statement)



Gross profit

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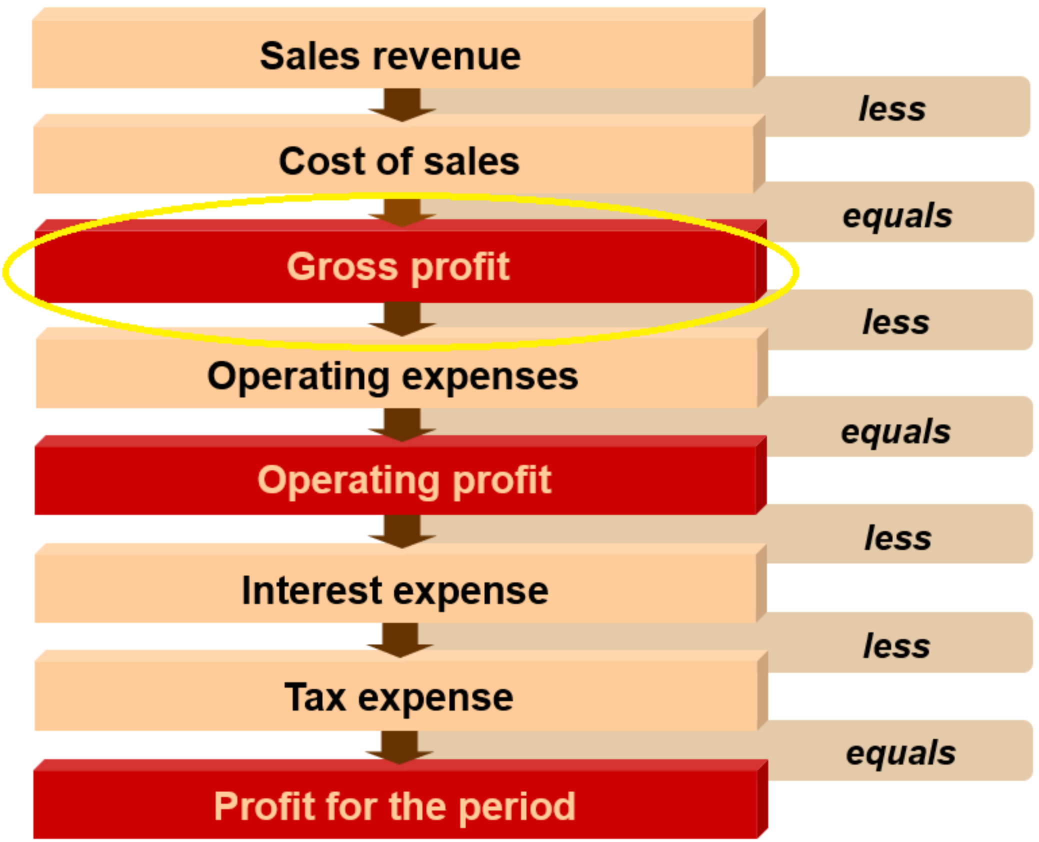
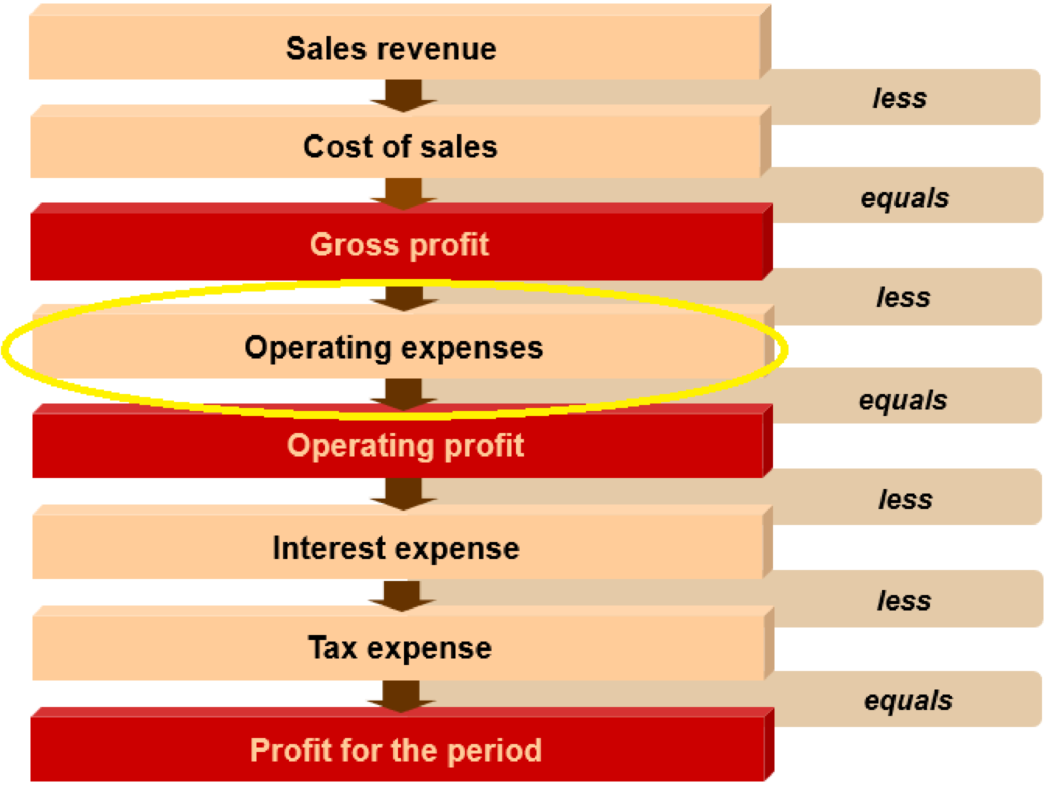


Operating expenses



Operating profit

Sales revenue
less
Cost of sales
equals
Gross profit
less
Operating expenses
equals
Operating profit
less
Interest expense
less
Tax expense
equals
Profit for the period

Tax expense

Sales revenue

less

Cost of sales

equals

Gross profit

less

Operating expenses

equals

Operating profit

less

Interest expense

less

Tax expense

equals

Profit for the period

Interest expense

Sales revenue

less

Cost of sales

equals

Gross profit

less

Operating expenses

equals

Operating profit

less

Interest expense

less

Tax expense

equals

Profit for the period

Net profit / “residual profit”

Sales revenue

less

Cost of sales

equals

Gross profit

less

Operating expenses

equals

Operating profit

less

Interest expense

less

Tax expense

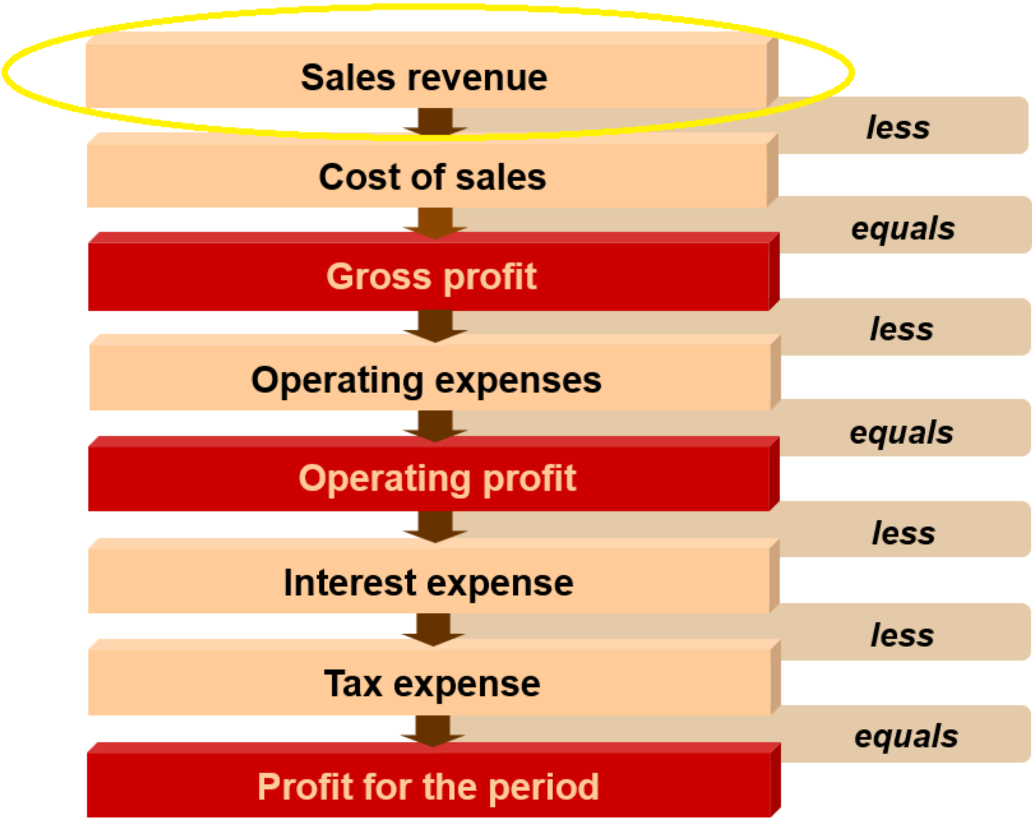
equals

Profit for the period

Revenue (IFRS 15)

Revenue

(the very important 1st line of income statement)



Revenue & IFRS 15

IFRS 15: Establishes principles for reporting about nature, amount, timing & uncertainty of revenue & cash flows arising from contracts with customers

Standard was issued in May 2014 and became effective for all annual periods beginning on or after 1 Jan 2018 (earlier application permitted)

Reasons for issuing IFRS 15

Revenue is an important number for assessing financial performance

Sales revenue usually single largest figure reported in financial statements

Investors place significant weight on revenue when evaluating past performance & future prospects

- Trend & growth rate in historical sales revenue drives many valuation models (e.g. free cash flow models)

Revenue recognition is also an area of financial reporting that has historically been susceptible to misstatement / fraud:

- Revenue being recorded that is dependent on uncertain future events
- Revenue being recorded before delivery completed
- Contract revenue being recognised before services are performed
- Fictitious sales agreements & documentation

Overview

IFRS 15 provides a single, comprehensive 5-step model to account for revenue

Core Principles:

Recognition: the entity shall recognise revenue to depict the transfer of control of goods or services to customers

Measurement: revenue shall be measured at the amount the entity expects to be entitled to in exchange for the goods or services transferred

- IFRS 15 requires distinct goods or services to be accounted for separately.

5 step process to recognise revenue

Step 1: Identify the contract(s) with the customer [RECOGNITION]

'Contract' is an agreement between 2 or more parties that creates enforceable rights & obligations (in a legal sense)

Parties have approved contract & are committed to perform respective obligations → Can be oral, written or implied by business practices

Can identify each party's rights regarding goods/services to be transferred

Can identify payment terms for goods/services to be transferred

Contract has commercial substance

It is probable the entity will collect consideration which it is entitled to in exchange of G/S

5 step process to recognise revenue

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Step 2: Identify contract 'performance obligations' [RECOGNITION]

Part of contract is a promise to provide G/S

If G/S are DISTINCT, the promise is a 'performance obligation' & should be accounted for separately

- G/S are DISTINCT if:
  - Customer can benefit from G/S on its own
  - Promise to provide those G/S is separately identifiable from other promises in the contract

5 step process to recognise revenue

Step 3: Determine the 'Transaction Price' [MEASUREMENT]

- 'Transaction Price': amount of consideration the entity expects to be entitled to in exchange for transferring promised goods/services (i.e. total contract consideration)

- TP should be adjusted for the time value of money.

- If the TP has a variable component: variable part only included in the TP if highly probable a significant reversal of revenue will not occur when the uncertainty is resolved

5 step process to recognise revenue

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Step 4: Allocate 'Transaction Price' to 'Performance Obligations' in the contract [MEASUREMENT]

Normally done based on the relative stand-alone selling price of each distinct G/S promised in the contract

If the selling price is not observable – estimate it !

5 step process to recognise revenue

Step 5: Recognise revenue when the entity satisfies a 'Performance Obligation' [RECOGNITION]

- Entity satisfies a performance obligation by transferring control of G/S to a customer (i.e. when customer obtains control of G/S)
- Amount of revenue recognised is the amount allocated to the satisfied performance obligation
- A performance obligation may be satisfied:

• AT a point in time – typically with promised goods OR

• OVER time – typically with promised services

➢ If recognised OVER time: entity recognises the revenue by selecting an appropriate method for measuring progress toward the complete satisfaction of the performance obligation.

Question

When does 'control' of goods pass from buyer to seller?

A sandwich ?

A ship on the sea ?

Step 5: Let's think about "performance" !

Goods & Services are an asset (even if only momentarily) when they are received & used

'Control': refers to the ability to direct the use of and obtain substantially all the benefits of the assets & to be able to protect/prevent the use of others in relation to those benefits

- Factors that MAY indicate a transfer of control:
  1. Point at which the entity is entitled to payment
  2. Legal title transfers
  3. Transfer of physical possession of an asset except for under consignment (where entity maintains control but not physical possession)
  4. Transfer of risks & rewards of ownership
  5. Customer has accepted the asset

Consignment Arrangements

When an entity delivers goods to another entity for sale to end customers, the entity should evaluate whether the other party has obtained CONTROL of the goods

•If the other party has not obtained control of the goods:

•Goods held in a consignment arrangement & should **NOT** recognise revenue upon delivery

• Revenue should only be recognised when control is transferred to the customer

•Indicators of a '**consignment arrangement**':

o Product controlled by entity until a specified event occurs (e.g. the final sale of the goods to the end customer) or until a specified period expires

o The entity is able to require the return of the goods or transfer the goods to a third party

o The dealer does not have an unconditional obligation to pay for the product (although it may be required to pay a deposit)

Warranties

Warranties are frequently included in arrangements to sell G/S whether explicitly stated or implied by the past business practices

•2 types of warranty that should be accounted for differently:

(1) Service-type warranties and

(2) Assurance type warranties

1. Service-type warranty

Warranties that provide an additional service to the customer in addition to the assurance that the G/S is as specified in the contract

Indicators:

- Customer has option to purchase warranty separately
- Warranty provides a service beyond fixing defects which exist at time of sale

A service-type warranty is a <u>distinct</u> service and a <u>separate performance obligation</u>, therefore:

- Using the estimated stand-alone selling price of the warranty, the entity must allocate a portion of the transaction price to the warranty
- The allocated transaction price is recognised as revenue over the period that the warranty service is provided

(2) Assurance-type warranty

Warranties that promise customer that the delivered G/S is as specified in the contract

An assurance-type warranty does not provide an additional G/S to the customer

An assurance-type warranty is **<u>not</u>** a separate performance obligation - it is effectively a guarantee of quality

Assurance-type warranties are accounted for as warranty obligations under IAS 37 (Provisions, Contingent Liabilities & Contingent Assets)

Onerous Contracts

An onerous contract is where the unavoidable costs of meeting the obligations of a contract, exceed the economic benefits expected to be received under it

Accounted for under IAS 37 (Provisions, Contingent Liabilities & Contingent Assets)

- Recognise a liability for expected losses on contract

Quiz

XCalc Ltd is a retailer which sells scientific calculators to schools

On the **21st December 2020**, XCalc receives a written order from a school for scientific calculators with a total retail value of €20,000

The cost of the inventory of calculators necessary to fulfil the order is €15,000 to XCalc

Due to Christmas break, calculators not delivered until **3rd January 2021**

The school paid for the order on **4th January 2021**

How would the above sale be reflected in financial statements of Xcalc for financial year ended 31st December 2020?

Answer

Share-based payments (IFRS 2)

Equity Settled Share-Based Payment

'Share based payment' transaction occurs when the entity receives goods or services in return for:

1. Equity instruments <u>OR</u>
2. Incurring a liability

We only focus on one type of share-based payment → Equity settled share-based payment:

- company issues own shares in exchange for goods and services

Scope of IFRS2

Concept of 'share-based payment' is broader than employee share options

IFRS 2 includes the issuance of share, or rights to shares, in exchange for goods and services

E.g.

- Share appreciation rights
- Employee share purchase plans
- Issuance of shares (or rights to shares) may depend on market or non-market related conditions

Equity Settled Share-Based Payments

Entity receives goods or services in exchange for its own equity instruments (including shares or share options)

- e.g. share option schemes offered to company employees

Typically schemes provide employees with the option of buying shares in the future at a pre-specified price

Goods + services received are measured at their fair value & recorded as an asset or expense

- There is a corresponding increase in equity

Equity Settled Share-Based Payments

There are 3 important dates:

1. **Date of grant** – date at which employees are granted the option at a future point in time.

- e.g. company on 1 Jan 2021 grants options to its directors to buy shares at €1.50 per share in the future
- 1 Jan 2021 is the date of grant of the options

2. **Vesting date** – this is the date on which director/employee qualifies for the option

- e.g. the option agreement on 1 Jan 2021 might stipulate that directors have to complete 3 years of service (dating from 1/1/2021)
- The vesting date of options would be 1/1/2024

3. **Exercise date** – this is the date that the directors/employees exercise their rights under the option agreement to purchase the shares

Equity Settled Share-Based Payments

Accounting treatment for 'equity settled share-based payments' is controversial topic !

Alves (2010) details the different arguments on whether or not ESSBP should be treated as an expense

Why shouldn't share options be treated as an expense?

- Does not meet the definition of an expense

CFW definition "expense": expenses are decreases in assets, or increases in liabilities that result in **decreases** in equity other than those relating to distributions to holders of equity claims

- Share options considered to be a capital transaction

- The potential dilution of share options already reflected in the diluted EPS figure

- The cost of share options cannot be estimated reliably

- Expensing share options will damage young companies
  - Deteriorate their income statements
  - Make it difficult to raise money
  - Economic consequences for early/growth start-ups

Why should share options be treated as an expense?

Disclosure is not a substitute for recognition

Cost of share options can be measured reliably

Expensing share options will not significantly damage young companies

- Investors comfortable with practice

IASB & IFRS 2 Position

Share options should be expensed

Share options regarded as payment in return for services provided by employees

Cost of providing share options is expensed over the vesting period

Thereby, matching cost incurred with the benefits derived from the employee's labour

Cost should be measured at the fair value of shares/share options at the date of grant of the options

Example 1

On 1 January 2021, M plc issued share options, giving each of four executives the right to purchase 25,000 shares at 25 cents a share. The value of the shares on 1 January 2021 was €1. A condition of the agreement was that the executive would complete three years of service from 1 January 2021. The nominal value of the company's shares was 10 cents. It should be assumed that the fair value of each share option on 1 January 2021 equals 75 cents.

The company's share price on subsequent dates:

1 January 2022 - €1.50

1 January 2023 - €2

1 January 2024 - €3

REQUIRED: Outline how the share options should be accounted for by M plc.

Example 1 Solution

What if share options lapse during the vesting period?

Overall effect of IFRS 2 is to expense the fair value (at grant date) of share options **that vest**

See Example 2

Example 2 Solution

If one of the executives in Example 1 were to leave on 1 Jan 2022, and therefore lose his/her share option rights, the following journals would be required:

Example 2 Solution …cont'd

What determines the fair value of the option at grant date?

IFRS 2 requires the fair value of equity instruments granted to be based on market prices, if possible

Terms + conditions of equity instruments should be taken into account when determining fair value

If market prices are not available, fair value should be estimated using a valuation technique to estimate price of equity instrument

IFRS 2 Questions

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Session 4

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Cash flow statement

Session 4: Cash flow statement

Introduction to cash flow statement

Statement of cash flows (IAS 7)

Introduction to cash flow statement

Statement of Cash Flows – Key Points

The Statement of Cash Flows provides supplementary information to the income statement

The income statement is prepared on an accrual basis

- Captures the changes between two balance sheets
- Provides more detail on increase in retained earnings for the year from operations
- A measure of performance

The statement of cash flow is prepared on a cash basis

- Captures the changes between a company's cash resources between two balance sheet dates
- A measure of performance

The income statement & cash flow statement provide complementary sources of information on an entity's performance (see examples in next slides)

Graph of cumulative income for KKD

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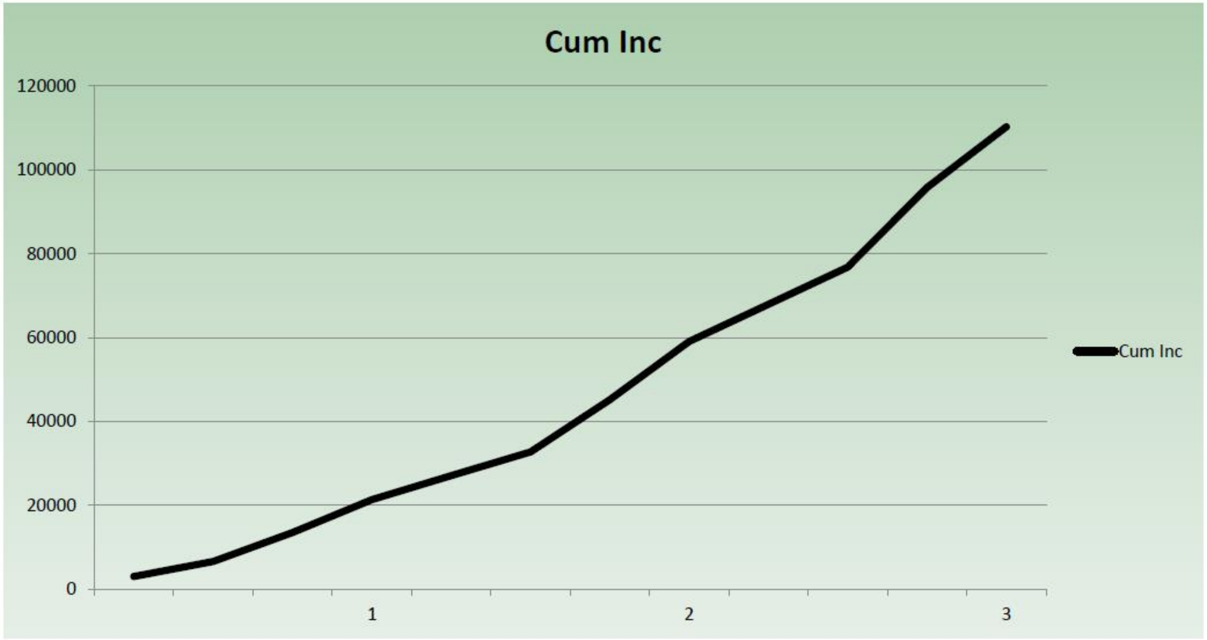
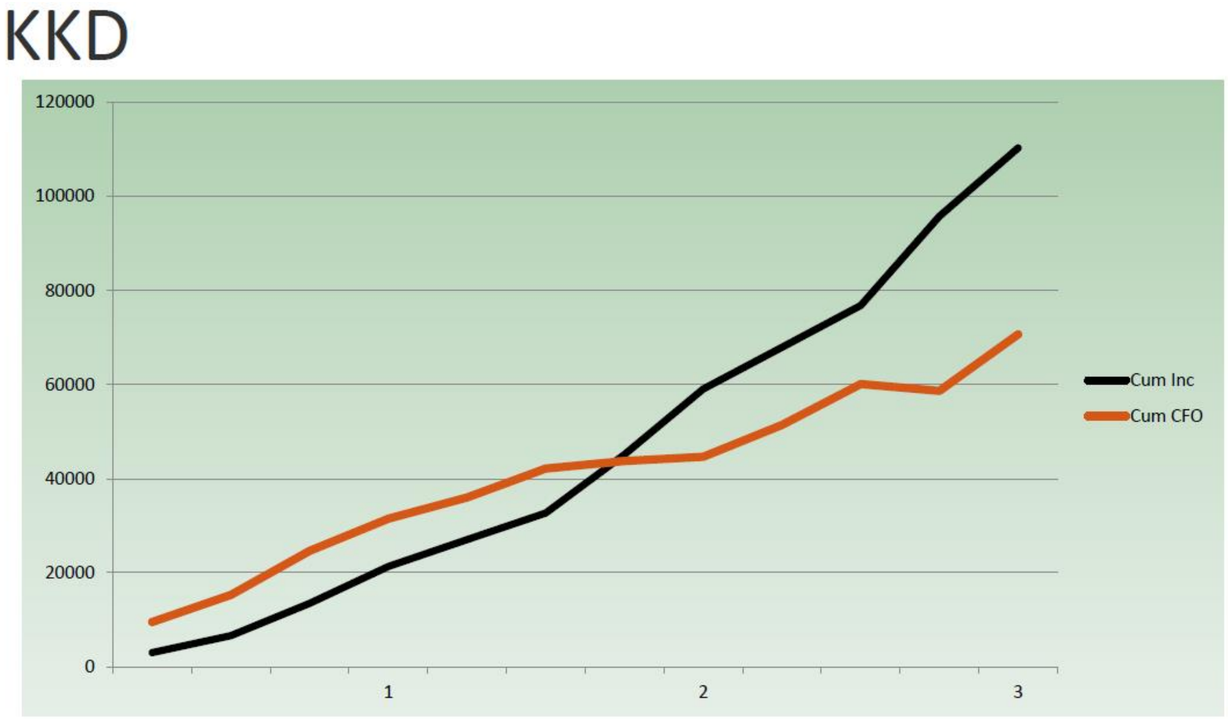
KKD



Graph of cumulative income and cumulative cash from operations for KKD



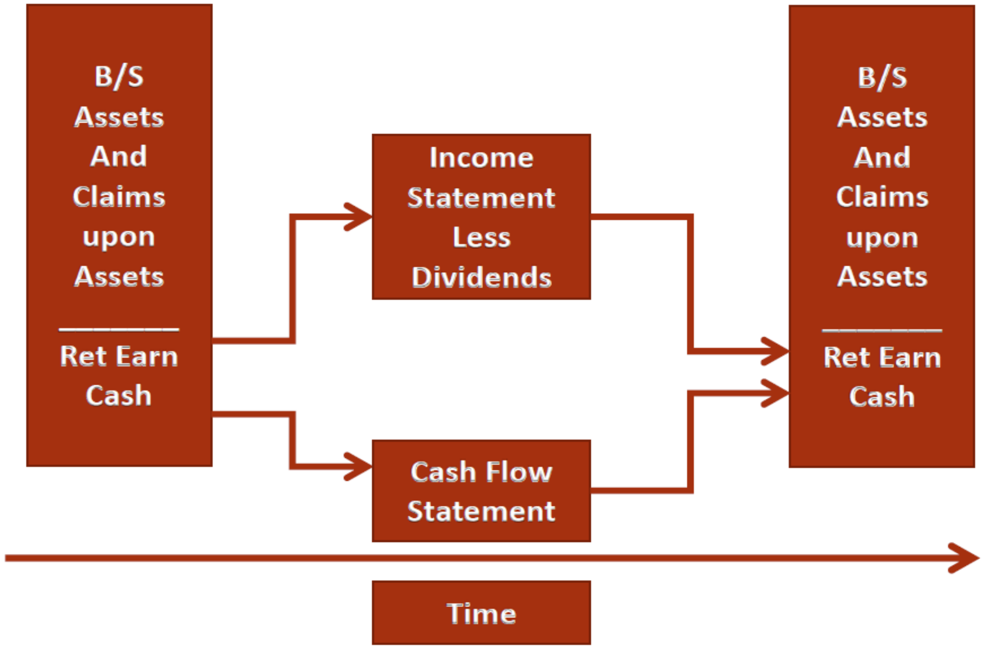
Overview

The purpose of the statement of cash flows is to:

- Report cash receipts & cash payments over a period of time
- Classify the cash flows as operating, investing & financing activities
  - Collectively exhaustive = there are 3 & only 3 categories. Everything must be classified as O, F or I
  - Mutually exclusive = if it is O then it cannot be F or I
- Detail the <u>changes</u> in the cash account on balance sheet

Articulation

Accounting as history …



Note: Cash Flow and Income are likely to be complements rather than substitutes

Purpose of the Cash Flow Statement

A statement of cash flows:

o Shows relationship of net income to change in cash balances (through the cash flow from operating activities section)

o Helps to predict future cash flows

o Evaluates how management generates & also uses cash

o Determines a company's ability to pay interest, dividends & debts when they are due

o Identifies specific increases & decreases in a firm's productive assets

The term "cash" also refers to cash equivalents:

o Cash equivalents are highly liquid short-term investments that a company can easily and quickly convert to cash e.g.

✓ Money market funds

✓ Treasury bills

Typical Activities Affecting Cash

Managers affect cash by three types of decisions:

- Operating decisions
- Investing decisions
- Financing decisions

Operating Activities

Operating decisions concerned with major day-to-day activities that generate revenues and expenses

Operating activities are transactions that affect the purchase, processing, and selling of a company's products and services

- Making sales
- Collecting accounts receivable
- Purchasing inventory
- Paying accounts payable

The first major section on the statement of cash flows is labelled **cash flows from operating activities**

Investing Activities

Investing decisions include the choices to acquire or dispose of long-term productive assets or long-term investments

Investing activities are transactions that acquire or dispose of assets that are expected to provide services for more than one year

- Purchasing or disposing of equipment

The investing section on the statement of cash flows is labelled **cash flows from investing activities**

Financing Activities

Financing decisions concerned with how to obtain or repay cash

Financing activities are a company's transactions that obtain resources from debt & equity transactions

- Issuance of additional share capital
- Borrowing money from the bank
- Repaying previous loans

The financing section on the statement of cash flows is labelled **cash flows from financing activities**

Typical Activities Affecting Cash

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Cash Inflows	Cash Outflows
Operating Activities:	
Collections from customers	Cash payments to suppliers
Interest and dividends collected	Cash payments to employees
Other operating receipts	Interest and taxes paid
	Other operating cash payments
Investing Activities:	
Sale of property, plant, and equipment	Purchase of property, plant, and equipment
Sale of securities that are not cash equivalents	Purchase of securities that are not cash equivalents
Receipt of loan repayments	Making loans
Financing:	
Borrowing cash from creditors	Repayment of amounts borrowed
Issuing equity securities	Repurchase of equity shares (including the purchase of treasury stock)
Issuing debt securities	Payment of dividends

N.B. IFRS permits entities to treat interest as a financing activity => CFO is ambiguous

The importance of cash flow

The income statement matches revenue & expenses using accrual concepts & provides a measure of economic performance

The statement of cash flows explains changes in the cash account rather than owners' equity

Free cash flow:

- Finance measure of cash management performance
- Refers to cash flows from operations less capital expenditures (& sometimes less dividends)

Cash Flow from Operating Activities

Two approaches may be used:

- **Direct method**:
  - Subtracts operating cash disbursements from operating cash collections
  - Is preferred by the IASB/FASB
- **Indirect method**:
  - Adjusts accrual-based net income from the income statement to reflect only cash receipts and disbursements
  - Is used by most companies

Reconciliation Statement

IASB & FASB require direct-method statements to include a supplementary schedule reconciling net income to net cash provided by operations

In other words, companies that use the direct method must also prepare a report using the indirect method (reconciliation schedule)

As a result, most companies use the indirect method

IFRS vs US GAAP

IFRS allows preparers to choose to include **interest expense** as either a **financing activity** or an **operating activity**

US GAAP requires **interest expense** to be an **operating activity**

- Therefore, CFO not well defined under IFRS
- Be careful of this difference, particularly if using CFO to derive a Free Cash Flow measure for a valuation model

Conclusions

Income & cash flow are describing many of the same economic events – hence they are complements

The statement of cash flows is a key financial statement and CFO may be computed as a residual or by using the direct or indirect methods

Free cash flow is widely used as a measure of cash generating ability

Be careful with CFO under IFRS as it may (or may not) include cash flows for interest

Cash Flow Statement: Google

KEY POINTS:

- CFO is a ***laundry list*** of accrual-based adjustments that the accountant has put through the income statement
- Can construct estimates of Free Cash Flow directly from cash flow statement
- Why does Google hold so much cash ?

Statement of cash flows (IAS 7)

Important Definitions

"Cash": **Cash on hand and demand deposits**

o Bank borrowings generally deemed to be financing activities

o However, when bank overdrafts are repayable on demand they form an integral part of an entity's cash management & therefore should be included as a component of cash and cash equivalents.

"Cash Equivalents": Short-term highly liquid investments that are readily convertible to known amounts of cash & which are subject to **insignificant** risk of changes in value

o Held for the purpose of meeting short-term cash commitments & not for investment purposes

o An investment normally qualifies as a cash equivalent only when it is expected to mature within 3 months from the date of acquisition (**NB: not from the end of the reporting period**)

Presentation of Cash Flow Statement

All cash flows must be classified under one of 3 headings:

1) **Operating activities**

2) **Investing activities**

3) **Financing activities**

Note: A transaction could include cash flows that can be separated from classification into the above groups

1. Operating Activities

Cash flows from operating activities mainly derived from the principle revenue producing activities of an entity

They generally result from transactions & events which determine profit or loss

An entity has a choice in presenting cash flows from operating activities, it may either use:

I. **Direct Method** (use of this method encouraged by IAS 7)

OR

II. **Indirect Method** (we focus on this method for purposes of this module)

The Direct Method

This method shows:

- Receipts from customers
- Payments to suppliers for goods and services
- Cash payments to and on behalf of employees

The Indirect Method

Under this method the net cash flow from operating activities determined by adjusting profit or loss by:

(a) Changes during the period in inventories, operating receivables & operating payables;

(b) Non-cash items in income statement

- e.g. depreciation, gains/losses on disposal of non-current assets, provisions, unrealised foreign currency gains and losses and undistributed profits of associates and non-controlling interest

2. Investing Activities

They are defined as the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

<u>*Examples:*</u>

(a) Cash payments to acquire property, plant and equipment, intangibles and other long-term assets.

(b) Cash receipts from sale of property, plant and equipment, intangibles and other long-term assets.

(c) Payments to acquire equity or debt instruments in other entities (including associates) held as assets – N.B. do not include those instruments which qualify as cash equivalents.

(d) Cash receipts from selling investments in other entities as in (c).

(e) Cash advances and loans to other parties and cash receipts from repayment of those advances and loans.

3. Financing Activities

Those activities that result in changes in size & composition of the contributed equity & borrowings of an entity

Examples:

(a) Cash proceeds from the issue of shares or other equity instruments

(b) Cash payments to acquire or redeem the entity's shares

(c) Cash receipts from the issue of:

- Debentures
- Loans
- Short or long-term borrowings
- Bonds, etc.

(d) Cash repayments of amounts borrowed

(e) Capital portion of a finance lease rental payment

Reporting Cash Flows from Investing & Financing Activities

General Rule:

Entities must report separately major classes of gross cash receipts and gross cash payments

Treatment of Interest & Dividends

Cash flows from interest & dividends received & paid must each be disclosed separately

Each must be classified in a consistent manner from period to period

However, IAS 7 is not prescriptive in the treatment of interest and dividends

Treatment of Interest & Dividends

Interest Paid, Interest Received & Dividend Received:

Interest paid/received & dividends received may be classified as **OPERATING** cash flows because they are included in the calculation of profit or loss

OR

May be included under **FINANCING** activities & **INVESTING** activities because they are costs of obtaining financial resources or returns on investments

Treatment of Interest & Dividends

Dividend Paid:

Dividends paid may be classified as a **FINANCING** cash flow - a cost of obtaining financial resources

OR

❖ Can be included as a component of **OPERATING** cash flows in order to assist users of financial statements to determine the ability of the reporting entity to pay dividends out of operating cash flows.

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Session 5

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Notes to the financial statements

Session 5: Notes

Introduction to Notes to the financial statements

Operating segments (IFRS 8)

Related party disclosures (IAS 24)

Introduction to notes

Introduction

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A wealth of information about the company – often ignored

- You will have to scrutinize the Notes for your group project

For example, following info disclosed:

- **Accounting policy descriptions – Note #1**
  - Tells you how figures prepared, assumptions made, estimates, etc

- **Contingent liabilities & contingent assets** – we talked about IAS 37 in Session 2

- **Segmental information (IFRS 8)**

- **Related party disclosures (IAS 24)**

Where to find the Notes

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STRATEGIC REPORT

DIRECTORS' REPORT

FINANCIAL STATEMENTS

SUPPLEMENTARY INFORMATION

Note #1: Accounting Policies Note

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Notes to the Financial Statements

FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2020

1. Statement of accounting policies

General information

Kerry Group plc is a public limited company incorporated in the Republic of Ireland. The registered number is 111471 and registered office address is Prince's Street, Tralee, Co. Kerry, V92 EH11, Ireland. The principal activities of the Company and its subsidiaries are described in the Business Reviews and note 35 'Group entities'.

Basis of preparation

The consolidated financial statements of Kerry Group plc have been prepared in accordance with International Financial Reporting Standards ('IFRS'), International Financial Reporting Interpretations Committee ('IFRIC') interpretations and those parts of the Companies Act, 2014 applicable to companies reporting under IFRS. The financial statements comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated Balance Sheet, the Company Balance Sheet, the Consolidated Statement of Changes in Equity, the Company Statement of Changes in Equity, the Consolidated Statement of Cash Flows, the Company Statement of Cash Flows and the notes to the financial statements. The financial statements include the information in the remuneration report that is described as being an integral part of the financial statements. Both the Parent Company and Group financial statements have also been prepared in accordance with IFRS adopted by the European Union ('EU') which comprise standards and interpretations approved by

Certain income statement headings and other financial measures included in the consolidated financial statements are not defined by IFRS. The Group make this distinction to give a better understanding of the financial performance of the business.

The consolidated and company financial statements have been prepared on the going concern basis of accounting. The Directors have considered the Group's business activities and how it generates value, together with the main trends and factors likely to affect future development, business performance including liquidity and access to financing as outlined in note 23, and position of the Group including the impact of the current COVID-19 pandemic. Due to the uncertainty of the ongoing duration and impact of the pandemic on mobility restrictions in different countries around the world, additional stressed scenarios, reflecting different levels and timing of the recovery, have been considered. This analysis indicated that, notwithstanding the current global pandemic, it does not affect the Group's ability to continue as a going concern.

There are no material uncertainties that cast a significant doubt on the Group's ability to continue as a going concern over a period of at least 12 months.

Basis of consolidation

Subsidiaries

The consolidated financial statements incorporate the

Note #1: Accounting Policies Note

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1. Statement of accounting policies (continued)

Property, plant and equipment

Property, plant and equipment, other than freehold land, are stated at cost less accumulated depreciation and any accumulated impairment losses. Cost comprises purchase price and other directly attributable costs. Freehold land is stated at cost and is not depreciated. Depreciation on the remaining property, plant and equipment is calculated by charging equal annual instalments to the Consolidated Income Statement at the following annual rates:

- Buildings	2% - 5%
- Plant, machinery and equipment	7% - 25%
- Motor vehicles	20%

The charge in respect of periodic depreciation is calculated after establishing an estimate of the asset's useful life and the expected residual value at the end of its life. Increasing/(decreasing) an asset's expected life or its residual value would result in a (decreased)/increased depreciation charge to the Consolidated Income Statement as well as an increase/(decrease) in the carrying value of the asset.

The useful lives of Group assets are determined by management at the time the assets are acquired and reviewed annually for appropriateness. These lives are based on historical experience with similar assets as well as anticipation of future events, which may impact their life, such as changes in technology. Historically, changes in useful lives or residual values have not resulted in material changes to the Group's depreciation charge.

Assets in the course of construction for production or administrative purposes are carried at cost less any recognised impairment loss. Cost includes professional fees and other directly attributable costs. Depreciation of these assets commences when the assets are ready for their intended use, on the same basis as other property assets.

Subsequent to the initial measurement, the liability will be reduced for payments made and increased for the interest applied and it is remeasured to reflect any reassessment or contract modifications. When the lease liability is remeasured, the corresponding adjustment is reflected in the right-of-use asset or in the Consolidated Income Statement if the right-of-use asset is already reduced to zero.

The Group has elected to record short-term leases of less than 12 months and leases of low-value assets as defined in IFRS 16 as an operating expense in the Consolidated Income Statement on a straight-line basis over the lease term.

The Group has also elected not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component further increasing the lease liability.

Assets classified as held for sale

Assets are classified as held for sale if their carrying value will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met if, at the financial year end, the sale is highly probable, the asset is available for immediate sale in its present condition, management is committed to the sale and the sale is expected to be completed within one year from the date of classification.

Assets classified as held for sale are measured at the lower of carrying value and fair value less costs to sell.

Intangible assets

Goodwill

Goodwill arises on business combinations and represents the excess of the cost of acquisition over the Group's interest in the fair value of the identifiable assets and liabilities of a subsidiary entity at the date control is achieved.

Note for each line item

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Consolidated Balance Sheet

AS AT 31 DECEMBER 2020

	Notes	31 December 2020 €'m	31 December 2019 €'m
Non-current assets			
Property, plant and equipment	11	**1,990.6**	2,062.9
Intangible assets	12	**4,687.1**	4,589.7
Financial asset investments	13	**37.0**	41.7
Investment in joint ventures	14	**17.8**	16.2
Other non-current financial instruments	22	**82.0**	82.7
Deferred tax assets	17	**33.8**	38.9
		6,848.3	6,832.1
Current assets			
Inventories	16	**975.6**	993.3

Note for each line item

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16 April 2021. The consolidated financial statements do not reflect this dividend.

11. Property, plant and equipment

	Notes	2020 €'m	2019 €'m
Group:			
Property, plant and equipment	(i)	**1,916.2**	1,963.4
Right-of-use assets	(ii)	**74.4**	99.5
		1,990.6	2,062.9

Operating segments (IFRS 8)

Segmental information

Financial statements are aggregate figures for **whole** business

Business may consist of distinct components – with different risk profiles, growth rates, etc

Google vs Amazon

- If you had to choose one, which one would you invest in today?
- Let's look at their income statements (remember: financial statements aggregate information for **entire** business)

Google income statements

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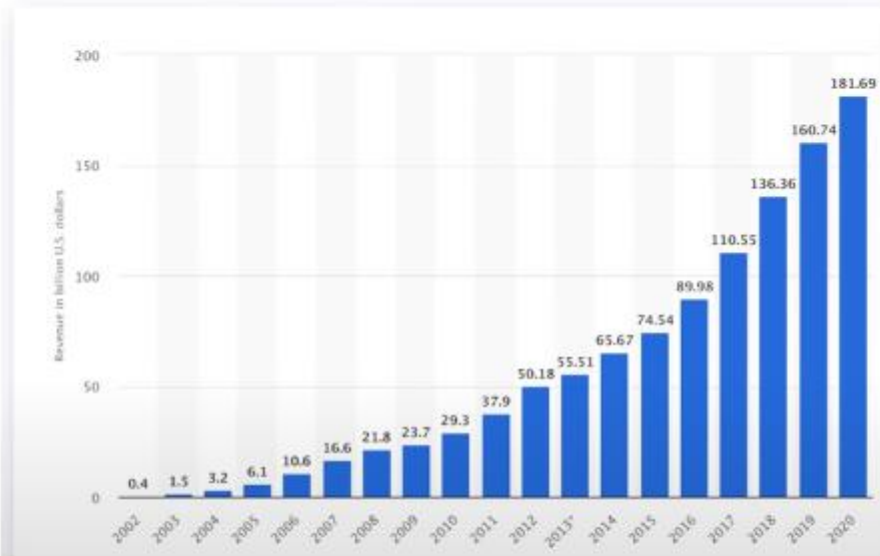
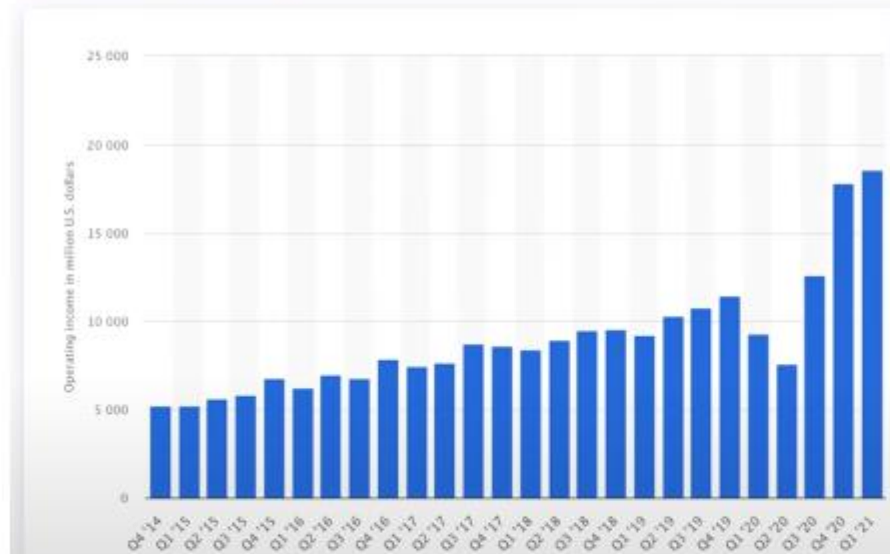
Annual revenue of Google from 2002 to 2020

(in billion U.S. dollars)



Operating income of Google from 4th quarter 2014 to 1st

(in million U.S. dollars)



Amazon income statements

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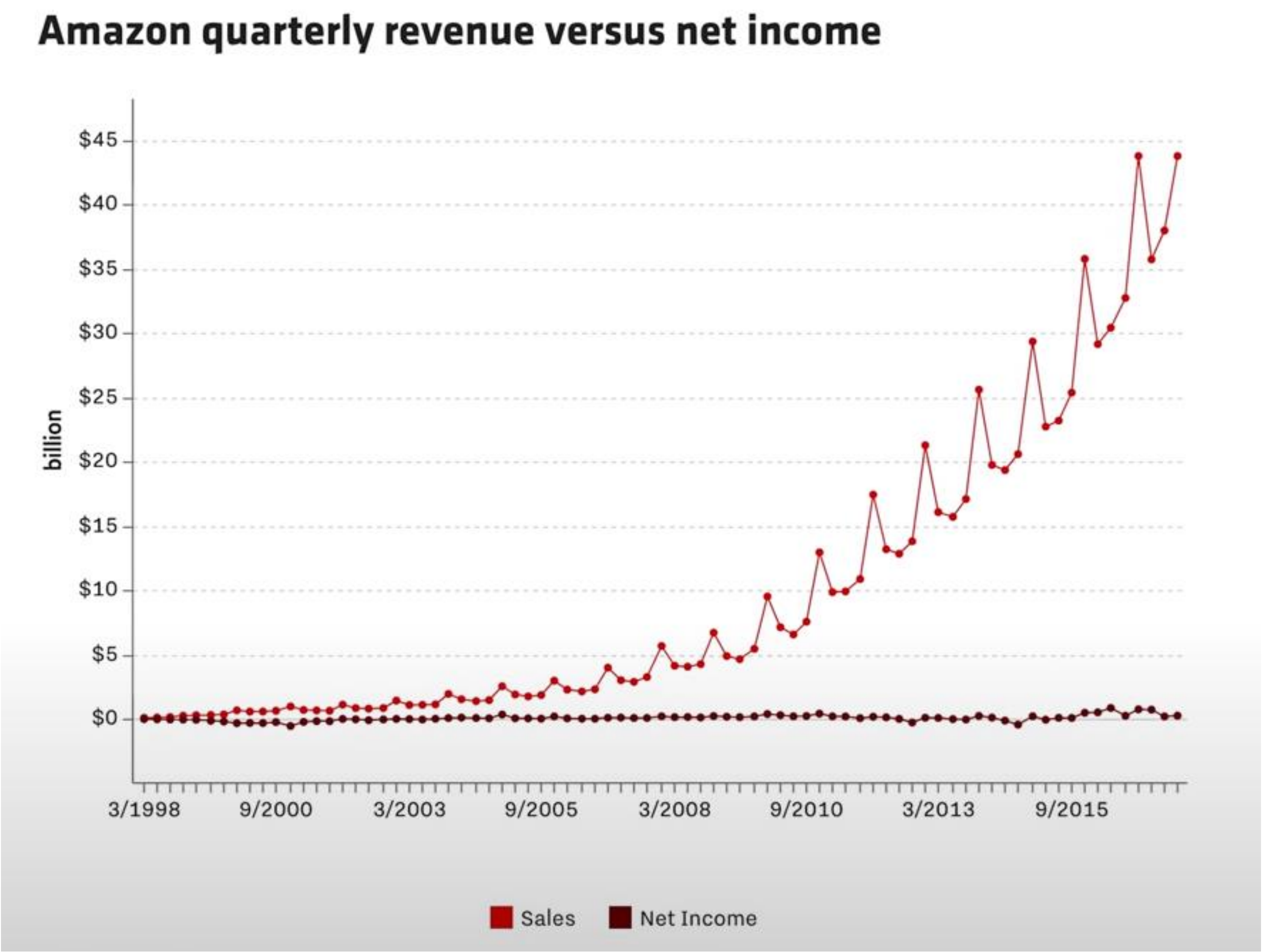

Innovation & Reinvestment

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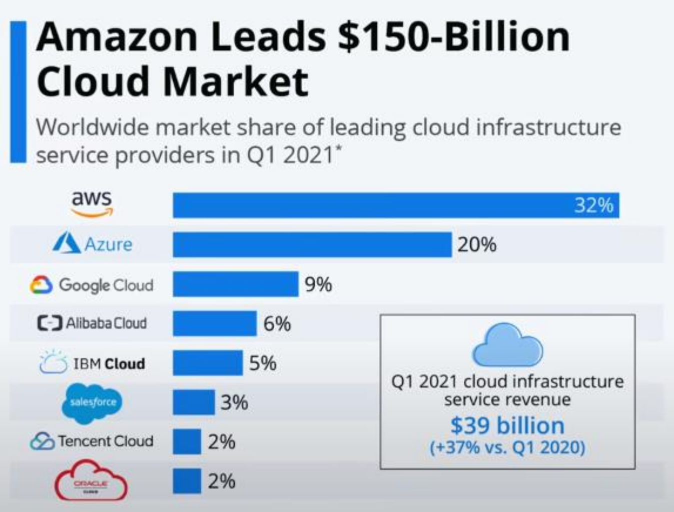
Previously we heard co-founder of Stripe saying accounting rules failed to capture value of intangible assets such as software

- Expenditure on developing new projects expensed rather than capitalized
- Deteriorates income statement / balance sheet / cash flow statement

How could this impact on the income statement (revenue / net profit) of Amazon & Google?



Innovation & Reinvestment

Amazon vs Google:

https://www.youtube.com/watch?v=9Fq15k9QPv8&list=PL91a1XTCKAC7DGcVG-LzpY3JoW0cThde_&index=4&t=365s

Watch: 6:05 - 8:53

Segmental information

The examples of Google vs Amazon shows the importance of segmental information

To analyse businesses with distinct components (risk, growth, etc.) → you need more granular financial information

IFRS 8 is the accounting standard which regulates the preparation of segmental information that companies must disclose

Segmental information is disclosed in the Notes to the financial statements !

Let’s look at the accounting rules / requirements

IFRS 8: Operating Segments

IFRS 8 (Operating Segments) is a disclosure standard

Does not address how transactions should be accounted for

Only addresses how information should be disclosed

The objective of IFRS 8 is for the organisation

To disclose information to enable the users of its financial statements to evaluate the nature and financial effects of:

- Types of business activities the entity engages in and
- Economic environments the entity operates within

Definitions

‘Chief operating decision maker’

- Term ‘chief operating decision maker’ is referred to in IFRS 8 (Operating Segments).
- Not defined in standard
- Refers to a function, rather than a title.
- Function could be fulfilled by a group of directors rather than a single director.

Definitions

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'Operating segment' – a component of an organisation

1) That engages in business activities from which it may earn revenues and incur expenses

- Including revenue & expenses relating to transactions with other components of the same organisation

2) Whose operating results are reviewed regularly by the organisation's 'chief operating decision maker' to make decisions about:

- Resources to be allocated to the segment and
- To assess its performance

3) For which discrete financial information is available.

Definitions

‘Reportable segment’:

An ‘operating segment’ or aggregations of ‘operating segments’ that meet size criteria specified in IFRS 8 (Operating Segments)

Identifying ‘operating segments’

Not all of the operations of an organisation will necessarily be an operating segment

For example, corporate headquarters does not have sufficient economic substance:

- it does not earn revenue or only earns revenue that is incidental to the activities of the organisation

Reportable Segments

Company must report financial & descriptive information about its 'reportable segments'.

'Reportable segments' are 'operating segments', or aggregations of 'operating segments', that meet specified size criteria:

(1) The operating segment's reported revenue, from both external customers and inter-segment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments	Income statement – sales revenue

OR

(2) The absolute measure of the operating segment's reported profit or loss is 10% or more of the greater of: (i) The absolute combined reported profit of all operating segments that did not report a loss and (ii) The absolute combined reported loss of all operating segments that reported a loss.	Income statement – net profit or loss

OR

(3) The operating segment's assets are 10% or more of the combined assets of all operating segments.	Balance sheet - assets

75% threshold for sales revenue

If total external revenue reported by reportable segments is less than 75% of the organisation's revenue:

Additional operating segments must be identified as reportable segments – even if they do not meet the size criteria for a 'reportable segment'

Additional reportable segments must be added until at least 75% of the organisation's revenue is included in the reportable segments

Example: Reportable Segments

P Ltd is a listed company. The following operating segments have been identified in the company:

	Revenue		Profit	Assets
	Internal	External		
Operating segment:				
A	550,000	300,000	70,000	5,000,000
B	300,000	2,600,000	750,000	10,800,000
C	50,000	450,000	100,000	1,000,000
D	-	1,550,000	200,000	5,000,000
E	100,000	400,000	80,000	2,200,000
TOTAL	1,000,000	5,300,000	1,200,000	24,000,000

Question:

Apply the principles in IFRS 8 (Operating Segments) to determine P Ltd's reportable segments.

Example: Reportable Segments

Let's consider IFRS 8's size criteria for 'reportable segments':

Segment reporting

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IFRS 8 (Operating Segments) does not define:

- Segment revenue
- Segment expense
- Segment result
- Segment assets or
- Segment liabilities

Standard only requires an explanation of how segment profit or loss, segment assets and segment liabilities are measured for each operating segment

- Therefore, organisations are provided with the discretion to determine what is included in segment profit or loss
- But in practice, organisations will be limited by their internal reporting practices.

Related party disclosures (IAS 24)

IAS24 – Related Party Disclosures

IAS24 is a disclosure standard

- **Disclosures made in Notes to the financial statements**

It is important that a user be aware of parties with whom the entity is related

And of transactions that have taken place with those parties during the reporting period

Users need to know if the figures in the financial statements do not reflect arm's length transactions between independent parties

Example

If a subsidiary, its policies and decision-making powers are effectively controlled by its parent company

An awareness of the parent-subsidiary relationship is an important disclosure that should be made in both companies' financial statements

Example

An entity may extend a loan to one of its directors at a discounted interest rate

Disclosure of this transaction is important if the information provided in the financial statements is to be considered as <u>complete</u>

Objective of IAS24

Objective of IAS24 is to draw attention to the possibility that financial statements may have been affected by:

- existence of related parties &
- by material transactions & outstanding balances with such parties

What is a related party transaction?

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

The following are examples of transactions that are disclosed if they are with a related party:

- Purchases or sales of goods
- Purchases or sales of property & other assets
- Rendering or receiving of services
- Leases
- Transfers of research and development

Who are related parties?

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

- Both entities are members of the same group
    - thus, a parent and a subsidiary are related parties, as are fellow subsidiaries
- One entity is an associate or joint venture of the other
- One entity is an associate or joint venture of a company in a group of which the other entity is a member

Who are related parties?

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(a)…cont'd

- Both entities are joint ventures of the same third party
- One entity is a joint venture of a third entity, and the other entity is an associate of the third entity
- The entity is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity
- The entity is controlled or jointly controlled by a person identified in the next slide

Who are related parties?

(b) A person, or a close family member of the person, is related to a reporting entity if that person:

- Has control or joint control over the reporting entity
- Has significant influence over the reporting entity or
- Is a member of the key management personnel of the reporting entity or its parent.

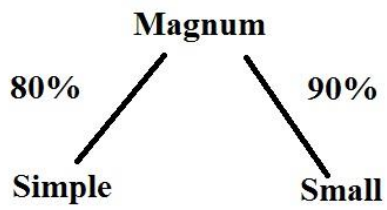
Definition

Key Management Personnel

those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including all directors (executive and non-executive)

Example 1: Parent & Subsidiaries

Magnum Limited controls two subsidiaries:
Simple Limited and Small Limited



Example 2: Member of Key Management Personnel

On 1 December 2020, Magnum Limited extends a loan of €200,000 to Roy Scapens, who is a brother of Magnum director, Tom Scapens

Example 3: Customer

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- During 2020, Magnum Limited sold a large quantity of goods to Brice Limited
- Neither company holds shares in the other

The following are NOT related parties

Two enterprises simply because they have a director or key manager in common

Two venturers who share joint control over a joint venture

Providers of finance, trade unions, public utilities, and government departments & agencies in the course of their normal dealings with an enterprise

A customer, supplier, franchisor, distributor, or general agent, simply because they transact a significant volume of business with such a party

Disclosure

Related Party Transactions

If there has been material transactions between related parties, an entity must disclose separately, for each category of related parties, the info for an understanding of potential effect of transaction on financial statements

This will include:

- The nature of the related party relationship
- The amount of the transactions
- The amount of outstanding balances, including commitments
- Provisions for doubtful debts related to the amount of the outstanding balances
- The expense recognized during the period in respect of bad or doubtful debts due from related parties

Disclosure

Relationships between parents and subsidiaries

Irrespective of whether there have been any transactions between a parent and a subsidiary, an entity must disclose:

- Name of its parent and
- Name of ultimate controlling party (if different)

If neither the parent, nor the ultimate controlling party produces financial statements available for public use, disclose name of next most senior parent that does produce public financial statements.

Disclosure

Management Compensation

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

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits, and
- Share-based payment

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