tbs

Business School

International Financial Accounting

Dr Sean Power, ACA

About

Lecturer: Dr Sean Power, ACA

Email: s.power@tbs-education.fr

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

INSPIRING EDUCATION
INSPIRING LIFE

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?

INSPIRING EDUCATION
INSPIRING LIFE

tbs Business School

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

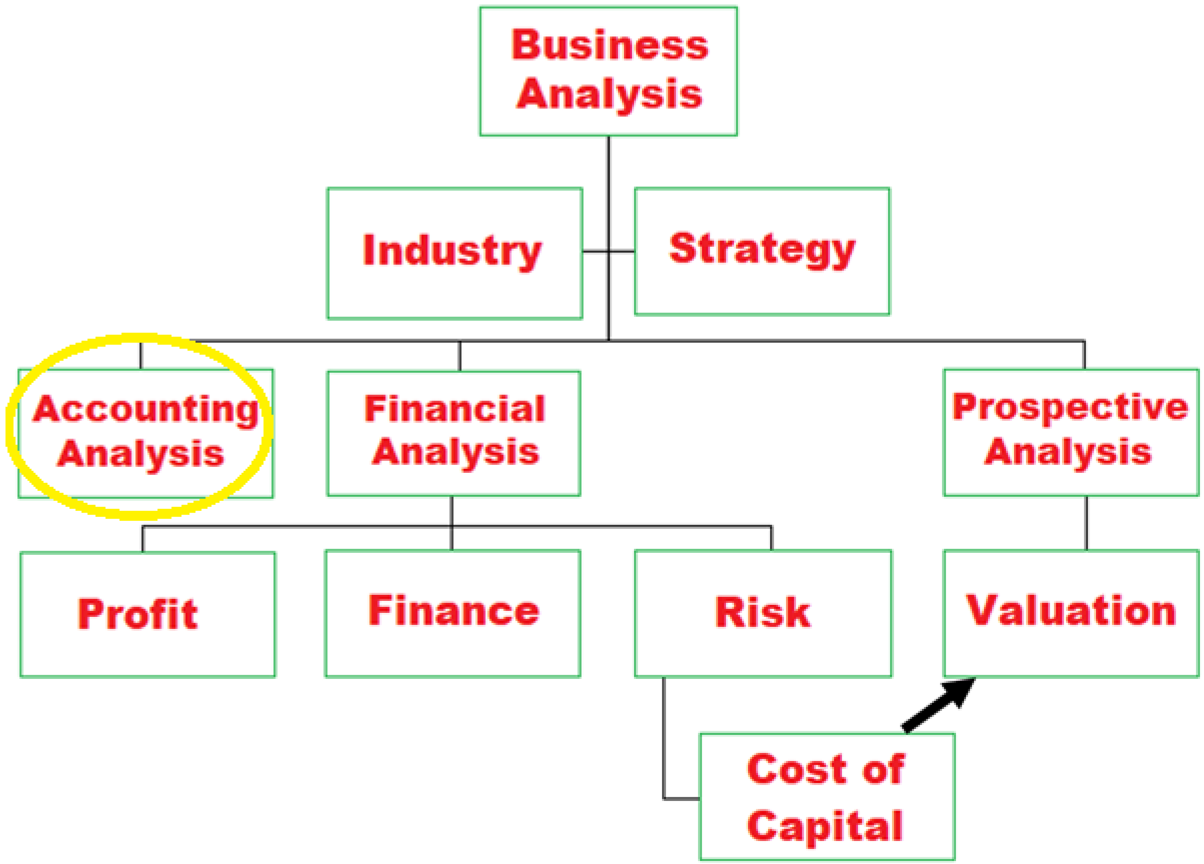
Max 6 pages report (excluding title & index pages)

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

INSPIRING EDUCATION INSPIRING LIFE

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

INSPIRING EDUCATION
INSPIRING LIFE

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?

The Rise of Accounting & Accounting Regulation

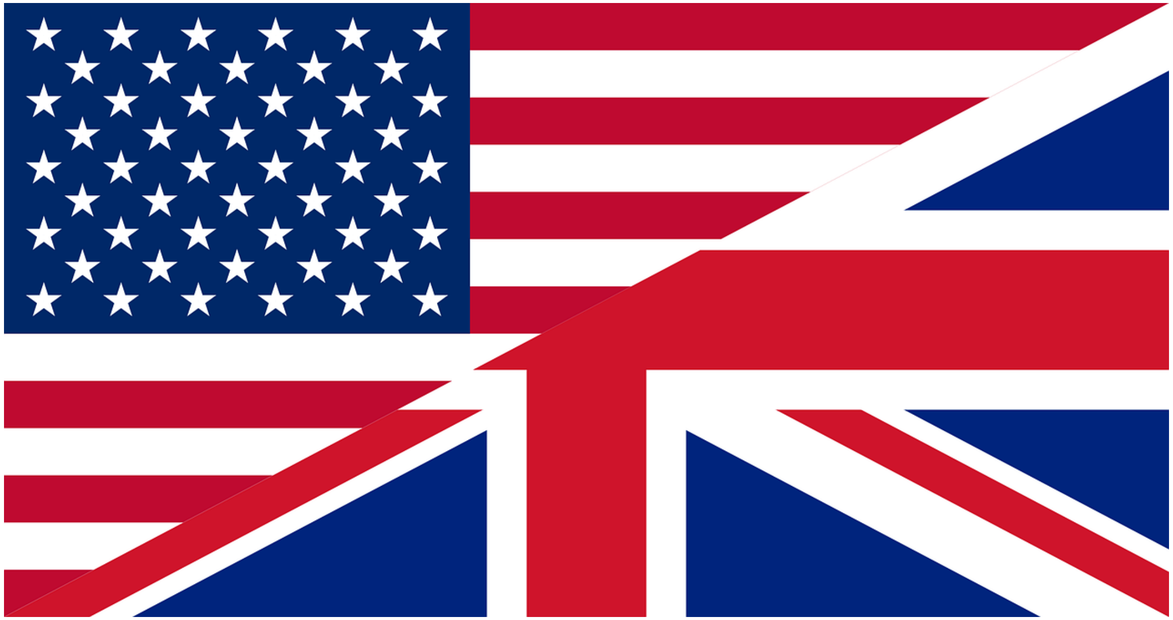
INSPIRING EDUCATION
INSPIRING LIFE

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

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*

INSPIRING EDUCATION
INSPIRING LIFE
tbs Business School

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

INSPIRING EDUCATION
INSPIRING LIFE

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

INSPIRING EDUCATION INSPIRING LIFE

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

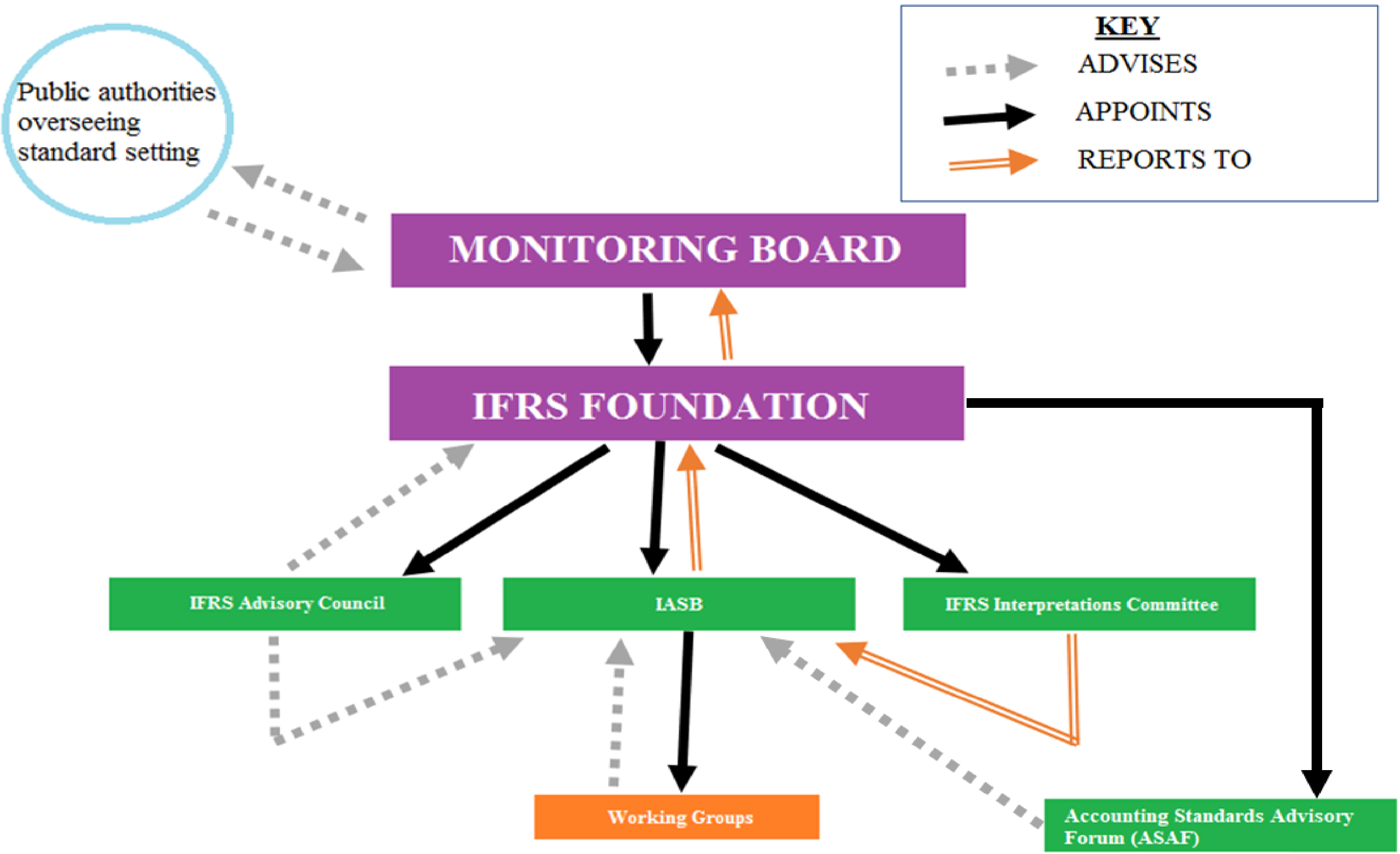
In 2001, the IASC restructures and becomes the International Accounting Standards Board (IASB)

- 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

INSPIRING EDUCATION
INSPIRING LIFE



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

INSPIRING EDUCATION INSPIRING LIFE

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

1. Relevance
   - Predictive value
   - Confirmatory value
   - Materiality

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

Enhancing qualitative characteristics

INSPIRING EDUCATION
INSPIRING LIFE

Enhancing qualitative characteristics:

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

Elements of financial statements

INSPIRING EDUCATION
INSPIRING LIFE

- 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

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

INSPIRING EDUCATION
INSPIRING LIFE

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

INSPIRING EDUCATION INSPIRING LIFE

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

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

INSPIRING EDUCATION INSPIRING LIFE

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

INSPIRING EDUCATION INSPIRING LIFE

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

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

Let’s look at the group example

Group example

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

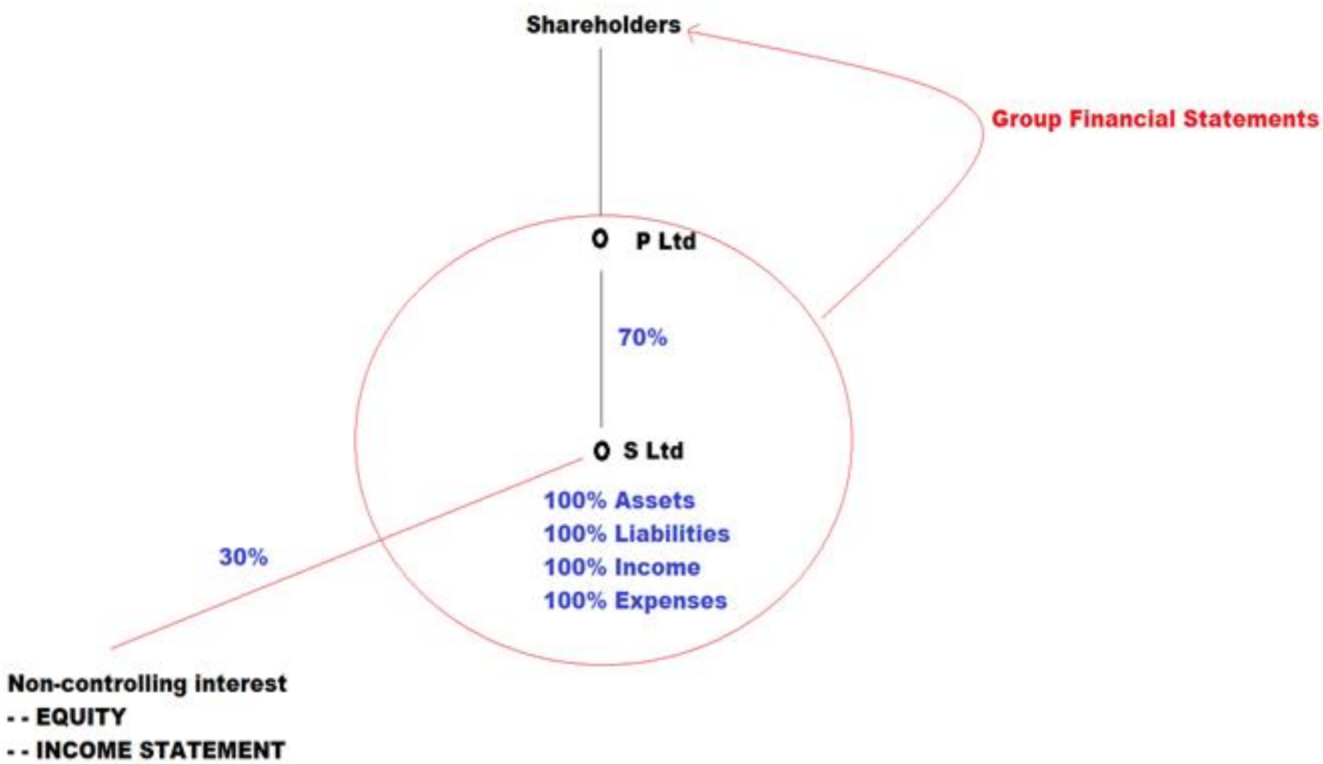
IFRS 3 - Goodwill

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

Consolidation rules attempt to address complexities of accounting for groups



Group Balance Sheet

INSPIRING EDUCATION INSPIRING LIFE

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

INSPIRING EDUCATION
INSPIRING LIFE

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

tbs Business School

INSPIRING EDUCATION INSPIRING LIFE

TOULOUSE • PARIS • BARCELONA • CASABLANCA • LONDON

AACSB ACCREDITED · EFMD EQUIS ACCREDITED · ASSOCIATION OF MBAS ACCREDITED