Module 5
The Framework for Financial Reporting

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Learning Objectives

By the end of this module you should understand:

1. The legal and quasi-legal framework within which companies draw up their financial statements
2. The principal features of the disclosure requirements contained in the International Financial Reporting Standards
3. The principles and basic mechanics of group accounting
4. How to read a published set of corporate financial statements
5. The role of the auditor and the report which he makes to the company

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We concluded from the first modules that we require considerable judgment and not a certain scientific formula for asset valuation and profit determination

Typical issues confronting managers with respect to financial accounting and reporting:

Inventories	What inventory valuation method should we use: LIFO or FIFO or average?
Overheads Allocation	What portion of overheads should be allocated to inventory, and what portion should be written off against this year's profit?
Depreciation	How should we depreciate our fixed assets? What is the useful life of the assets?
Revenue Recognition	When should we recognize revenue – on payment or at time of invoice?

The company's reported profit will be directly affected by how management decides to answer these questions

However, managers cannot be left alone with loose discretion in these matters

Because this will jeopardize:

Credibility	Reliability	Usefulness of financial statements

There is always a temptation to draw up financial statements which exaggerate the efficiency of performance

The material in this module will be quite different and less numerical

Describe the ***framework*** within which companies must operate in financial reporting

Describe the ***additional information*** that a company must disclose to its statements

However this module:

Introduces the reader to the ***legal*** and ***quasi-legal*** framework

NOT to be considered as a comprehensive checklist of disclosure requirements

Through:

"IFRS"

International Financial Reporting Standards

"IASB"

International Accounting Standards Board

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The word 'disclosure' implies a degree of resistance on the part of a company to make public some internal information

The Disclosure Concept

Disclosure

Implies a degree of ***resistance*** on the part of the company to make public certain aspects of its affairs

Many Questions arise:

Why should a company be made to disclose information?

Why should the company be reluctant to disclose to the public what is going on?

What has the company got to hide?

The first of these questions is the easiest to answer and is related to the limited liability status of companies

	Sole Traders & Partnerships	Incorporations
Liability Status	Liability is beyond the extent of their capital accounts into their personal possessions	Limited Liability to the extent of their shareholdings
Creditors	Can Easily pursue them beyond their share	Less able to recover money
Shareholders	Are more attached to management	Are divorced from management
Disclosure Need	Law recognizes that there is no need on such entities to disclose a statement	Law protects both creditors & shareholders by forcing companies to disclose certain information

Managers disclose the minimum information required by the various regulations to avoid external interference

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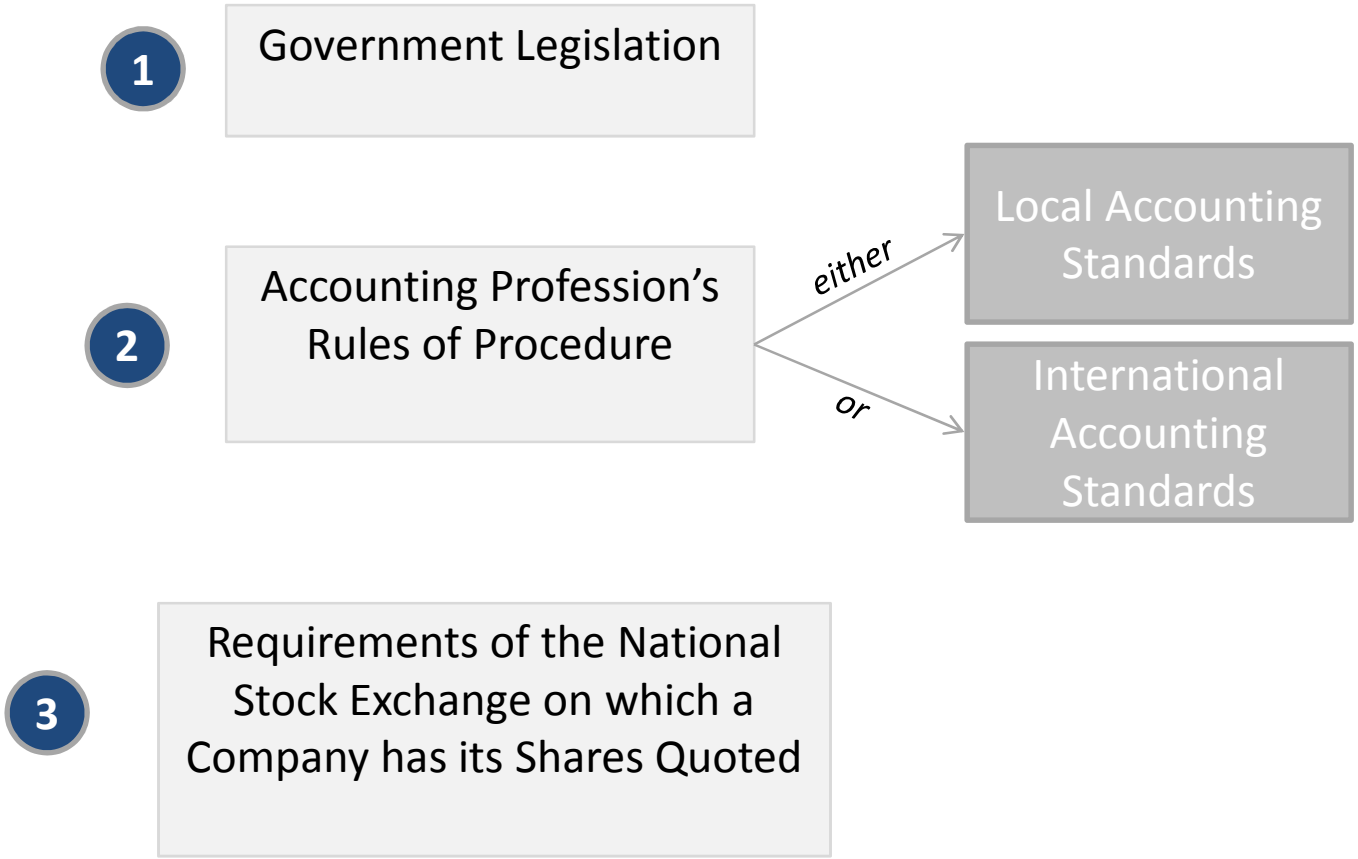
There are three main sources of rules which govern the disclosure practices of all companies



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A company's auditor must certify every year that a true and fair view has been given of the company's profits and state of affairs

The Overall Requirement of the Law:

"The company's profit and loss account & balance sheet shall give a ***true*** and ***fair*** view of, respectively, the profit or loss for the financial year, and the state of affairs as at the end thereof."

According to Accepted Accounting Principles

Free from deliberate bias

Using accurate figures

Free from manipulation or concealment

Using reasonable estimates

Much of the information is given by way of notes which are keyed into summarized figures on the accounts

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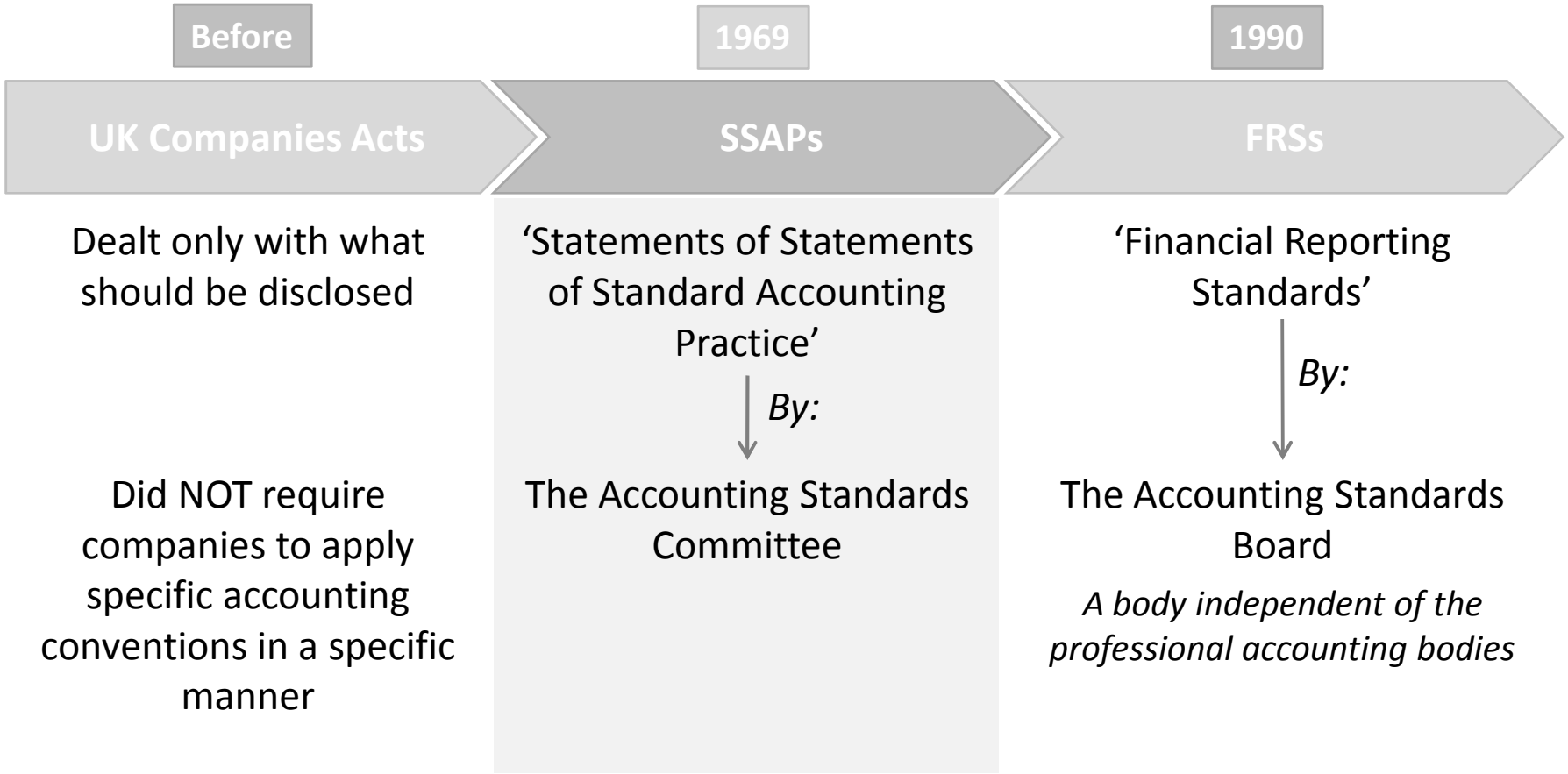
In this part we'll cover how the accounting standards were developed in the UK throughout the last century



The weakness of the UK accounting standards program up to 1990 lays in the fact that companies chose not to abide by specific standards

The main difference between the companies acts and the accounting standards is the disclosure requirements

UK Companies Acts

Companies must disclose certain information (of a financial nature) during the accounting year under review

Accounting Standards (more influential)

Set controls on how the numbers in the financial statements are to be compiled

Any: Change in Accounting Policies → *Should be* → Disclosed / Quantified in terms of its effect on profits

Accounting Standards cover:

- *A switch from FIFO stock valuation to LIFO*
- *Work-in-Progress*
- *Group accounts*
- *Depreciation*
- *Leases and hire-purchase contracts*
- *Pension costs*
- *Stocks*
- *Related party transactions*

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Listing requirements of the Stock Exchange extend the requirements of the Companies Acts rather than the accounting standards

If a company seeks a quotation on a recognized stock exchange:

1. Supply the exchange with detailed information about the management and financial structure of the company
2. Annually provide certain information in its report and accounts
   - Reasons for any departures from accounting standards
   - Geographical analysis of sales turnover
   - Details of shareholdings of more than 20% in other companies
   - Details of directors' shareholdings in the company
   - Details of dividends waived by directors or shareholders
3. Prepare half-yearly profit reports, to be disclosed in the press

Listing requirements make no attempt to prescribe accounting conventions for companies to adopt

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Financial Reporting in Action

In this module we will have an extract from ***MBA's published accounts*** for 20x2, with some of the relevant notes and disclosure requirements

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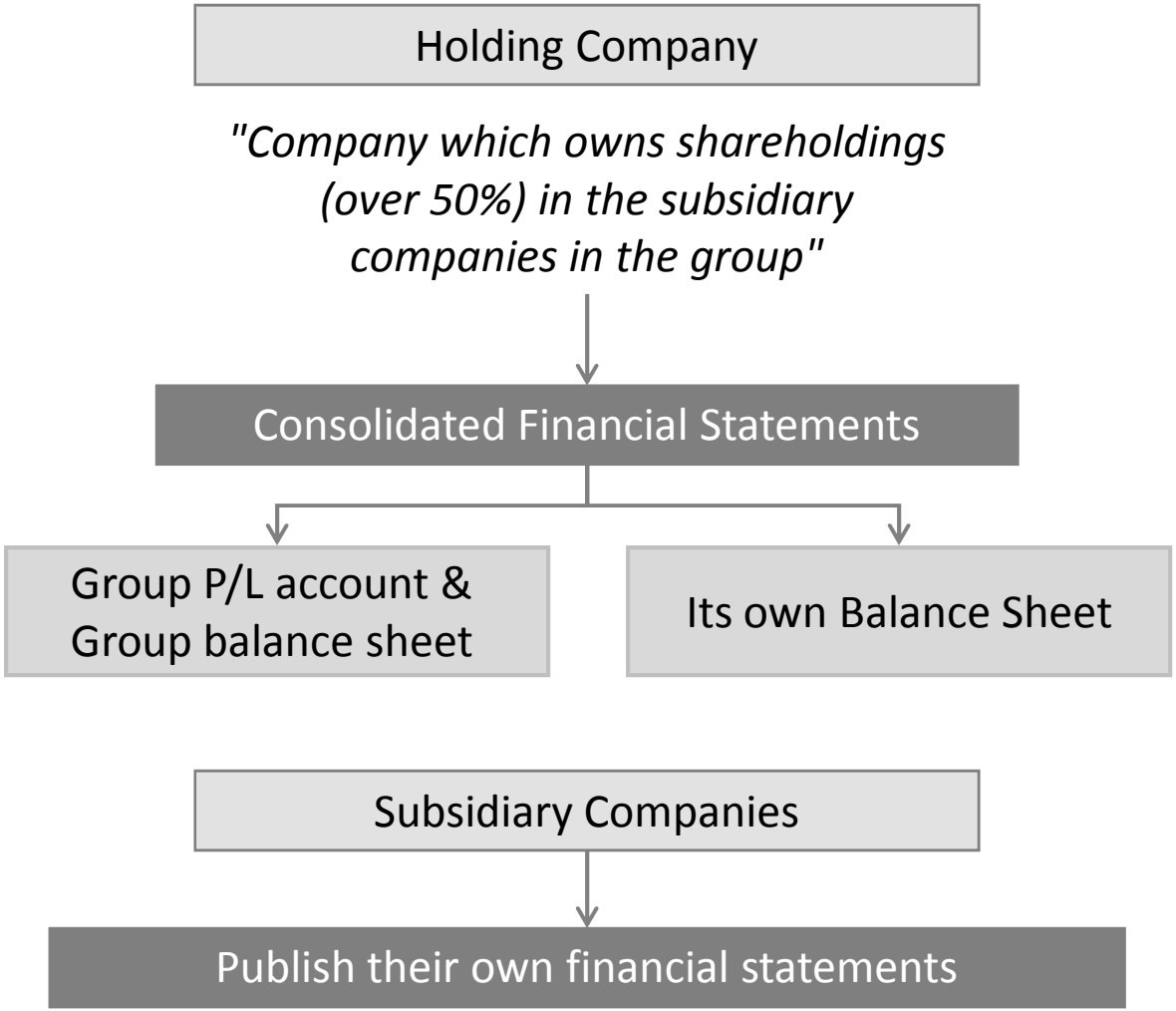
The modules so far have concentrated on the financial accounting and reporting of the activities of a single company



It is useful to consider the basic principles of group accounting through the following example

Example

Ben Nevis Co. Ltd acquired 70% of the ordinary share capital of Ben Lomond Co. Ltd to form the Ben Nevis Group of Companies. It acquired the holding in Ben Lomond by paying €40 in cash.

Before the acquisition, Ben Nevis's balance sheet was as follows:

	€	€
Fixed assets		100
Current assets (mostly cash)	100	
Current liabilities	100	
Net current assets		–
Total assets *less* current liabilities		100
Owners' equity		100

Ben Lomond's financial statements shows no sign of Ben Nevis's acquisition other than a brief note in the notes to accounts

On acquisition, Ben Lomond's balance sheet was as follows:

	€	€
Fixed assets		50
Current assets	50	
Current liabilities	50	
Net current assets		–
Total assets *less* current liabilities		50
Owners' equity		50

‘Investments in subsidiary’ in Ben Nevis’s balance sheet is replaced by the underlying net assets of subsidiary plus the goodwill

After the acquisition Ben Nevis’s balance sheet looked like this:

	€	€
Fixed assets	100	
Investment in subsidiary	40	140
Current assets	60	
Current liabilities	100	
Net current assets		(40)
Total assets *less* current liabilities		100
Owners’ equity		100

Ben Nevis acquired only 70% of Ben Lomond’s equity:

70% × Net assets €50 = €35, though Nevis paid €40

Difference of €5 is known as "*Goodwill*"

An acquirer is willing to pay for net assets which he believes possess a higher intrinsic value than that appearing in the balance sheet

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Group accounts should reflect a true and fair view of the whole group's operations from the perspective of holding company shareholders

Ben Nevis **Group** balance sheet would appear on acquisition as follows

	€	€
Fixed assets		150
Intangible asset (goodwill)		5
Current assets	110	
Current liabilities	150	
Net current assets		(40)
Total assets *less* current liabilities		115
Owners' equity		100
Minority interest		15
		115

Sum of holding's & subsidiary's fixed assets

= €265-€150

30% minority interest to Ben Lomond

'Goodwill' in the balance sheet refers to the purchased goodwill on the acquisition of a subsidiary

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We will use extracts from the annual report and accounts of the MBA Company and The Award Company for the year ending in 20x2

Two points to be made:

1	The principles on which the text of the modules will be focusing are basic and go beyond relevant legislation existing at the publication time
2	Any major public company will issue its annual report and accounts on request to the Company Secretary

A glance at these two accounts in the Appendices (5.1 and 5.2) will reveal the complexity involved and level of detail required

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Experienced readers of annual accounts always start their examination with the enterprise's Accounting Principles and Policies

Refer to MBA's report on page 5/36

Accounting policies

Are the specific accounting bases selected and consistently followed by a business enterprise

Regarded by the management as the most appropriate to its circumstances and best suited to present fairly its results and financial position

These Accounting Principles and Policies are required by IAS 1 Presentation of Financial Statements

IAS 1 says this:

The accounting policies section of the notes to the financial statements should describe the following:

a) the measurement basis (or bases) used in preparing the financial statements; and
b) each specific accounting policy that is necessary for an understanding of the financial statements.

We should appreciate the wording of at least four policies at this stage in their studies

Corporate Structure *"Policy 2"*

- MBA Group comprises 174 entities, including all material subsidiaries, 17 special securities funds and 21 trusts. Note the 76 dormant subsidiaries.

Goodwill *"Policy 4"*

- It represents the value for intangible assets such as reputation, brands and knowledge which do not appear on the balance sheet of the acquired company
- This amount is subjected to an annual impairment affecting the P/L

Depreciation *"Policy 6"*

- Found under the bold title Property, plant and equipment
- Management makes an assessment of the useful lives of the various asset group

Inventories *"Policy 6"*

- Valued in a prudent manner so that profit is not recognized until it has properly been earned

Management enjoys only a limited freedom in the selection of accounting policies

True and fair view

Management is free to select a method which is suitable for their industry as long as it reflect a true and fair view of the state of affairs of their company

External auditors

External auditors must approve the selection of accounting policies.

If they do not, they must make reference to their disapproval in their report to shareholders

Consistency

Management must consistently apply the policies from year to year unless the underlying economic conditions have materially altered so that a consistent application would prevent a true and fair view of the state of affairs of the company from being shown

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IAS 1 requires certain information to be disclosed in the notes (Notes 8–16) since a typical published P/L account does not tell much

See MBA's P/L Account and Notes 8-16 (Page 5/32)

Notes

Income Statement

- Split between industrial operations and financial operations
- "IAS 14" requires disclosure for both business segments and/or geographical segments (one is primary & the other secondary)

Cost of sales Breakdown "Note 8"

- 6 separate sub-headings
- It would be more useful to know the breakdown in manufacturing costs among raw material, labor and manufacturing overhead

MBA's group income statement is supported by detailed notes in order to avoid clutter on the income statement itself

An important question to be answered in the notes: what happens to the group profit of €2222 million?

Notes (Continued)

Net Profit

- Already taxed
- Deduct €0.238 Mio. minority interest *"Note 14"*

Profit Allocation

- 2 types of shareholders, ordinary and preferred *"Note 15"*
- €3.30/share Profit earned by ordinary shareholders
- €0.62/share as dividend
- €2.68/share for business growth

Earnings per share

- The stock market likes to see it growing
- Upward trend in EPS from €2.89 in 20x1 to €3.30 in 20x2

Ordinary shareholders

Receive no priority and take the ultimate risk should the company get into trouble

Preferred shareholders

Receive preferences in terms of dividends and pay-outs on the company's dissolving

IASB has done away with exceptional and extraordinary items and speaks instead about material items

Exceptional/ extraordinary item	*Vs.*	Materiality
"Used to Be"		***"Currently Set by IASB"***
Companies were required to disclose items of income or expenditure if the size of these transactions was sufficiently large to distort the results from normal		'Omissions and misstatements of items are material → if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements'
Exceptional → associated with the normal operations and could recur ***Extraordinary*** → associated with the normal operations but unlikely to recur		Depends on the ***size*** and ***nature*** of the omission or misstatement judged in the surrounding circumstances

IAS 1 requires companies to disclose items which are material but it is silent as to where they should be disclosed, in the P/L Account or the notes

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Two items should be noted in MBA's balance sheet and its notes that refer to consolidated accounts, first is minority interest…

1. Minority Interest "Note 27"

Why Minority Interest?

Subsidiaries' total assets and liabilities

↓ *Aggregated in*

The group balance sheet

↓ *Though*

MBA has not legal ownership of them

↓ *Thus*

Minority interests' stake in their subsidiaries

↓ *To be recognized in*

The group accounts

How to deal with minority interest?

Naturally

When this net amount is significant

↓

Disclosed as a separate line item on the face of the balance sheet adjacent to the equity figure

MBA Case

Minority interest is very small

↓

Section Minority Interest in Note 27

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…Second is goodwill

2. Goodwill "Notes 17 and 18"

Note 18

Quantifies the amount that MBA has paid for goodwill as a result of its various acquisitions → €24 million → Sufficiently insignificant

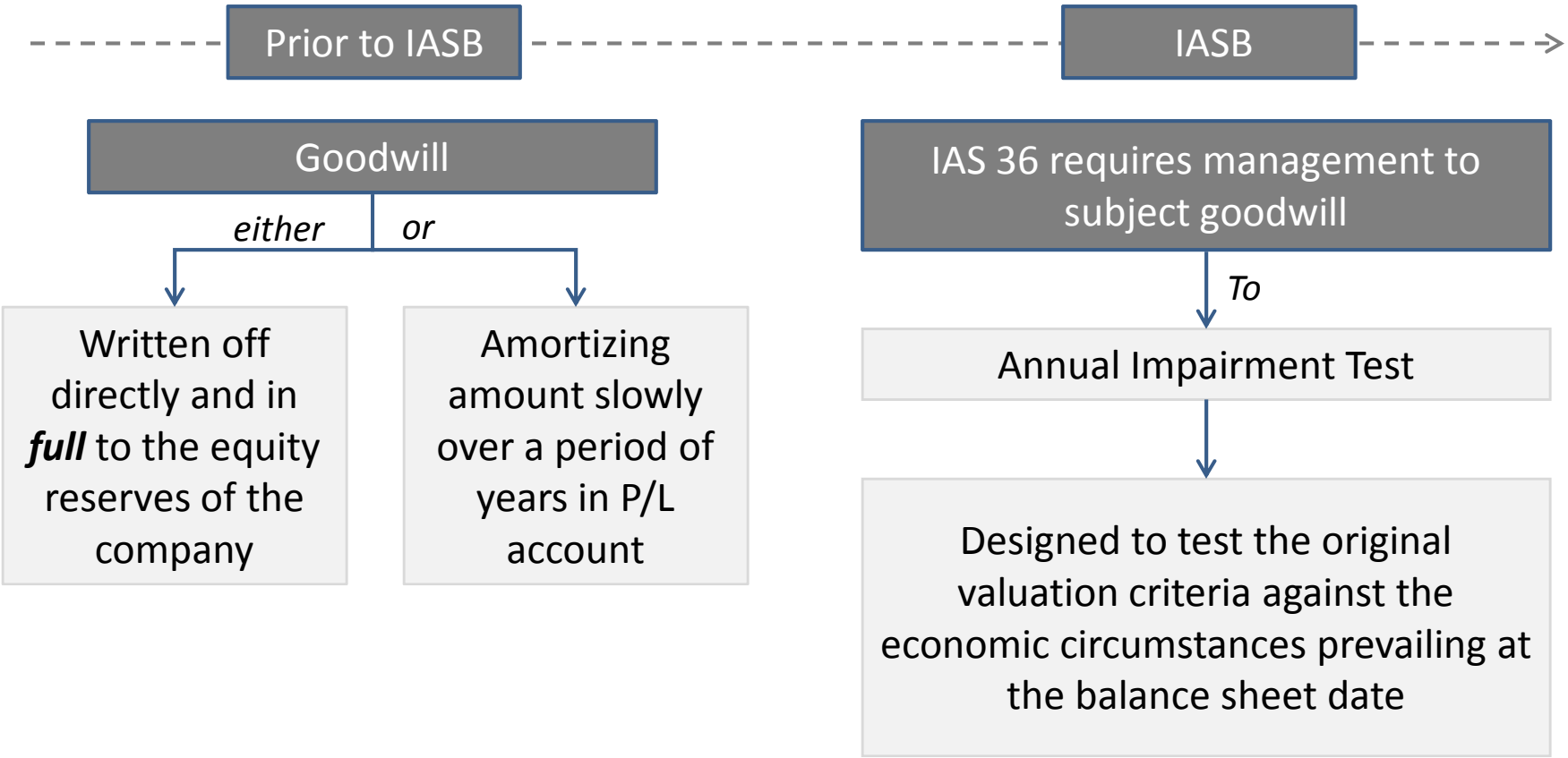
If the amount is significant

Indicates a group's aggressive acquisition strategy

And/or

Management's willingness to pay handsomely for those attributes that constitute goodwill

We will consider goodwill in a later module but for now we should be aware of a major change in the accounting treatment of goodwill



Consider the capital and reserves of MBA "Note 27“; two items are worthy of explanation

Share Capital: Authorized and Issued

Under provisions of most countries’ companies legislation:

Entities are authorized to raise money

Through selling ordinary shares

Usually:

Authorized Capital > Money required for operations

So that the company has the legal authority to sell more shares to finance expansion

Capital Reserves

Company issues shares on numerous occasions:

Prices the shares in accordance with market conditions

Price is in excess of par value

If MBA is to issue shares:

Par value = €1

Market value ≈ €36

Issue price should be around €36 (or less)

Difference (€36 less €1) is ***capital reserve*** *or* ***share premium***

Attentive readers will have spotted the use of the title "non-current asset" used in MBA report and not fixed assets

IAS 1

Requires companies to distinguish current assets and liabilities from non-current ones

Though it does not mandate the term non-current assets, it is widely used

It does not require entering amounts to the last euro or cent

It extends flexibility to the company provided that the truth and fairness of the accounts is not affected by such rounding

Examples

1. ***MBA's non-current assets amounting to €22,753 million:***
   Its accounts would not be more clarified, nor informative if they entered the exact amount of €22,752,876,214.72

2. ***A small enterprise whose fixed assets amounted to €478.98***
   It might not show a true and fair view by rounding up to €500 as the difference is material

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From the complexity of MBA's account vs. the simplicity of the sole trader's accounts, we may feel that the two entities are different which is untrue

Sole Trader: Balance sheet as at end of Action 7

	€	€
Non-current assets		
Plant and equipment	12 000	
Less: Depreciation	50	11 950
Current assets		
Inventories	5 500	
Debtors	750	
Cash	4 960	
	11 210	
Less: **Current liabilities**		
Creditors	3 000	8 210
		20 160
Represented by:		
Capital introduced	20 000	
Profit for the year	160	
		20 160

In fact, both sets of financial statements bear some resemblance in structure

MBA: Balance sheet as at 31 December 20x2

	€	€
Non-current assets		
Total non-current assets less depreciation		22 753
Current assets		
Stocks (inventories)	6 467	
Debtors (receivables from three sources)	33 396	
Investments	1 832	
Cash	2 128	
	43 823	
Less: **Current liabilities**		
Trade payables and other liabilities*	5 771	38 052
Other assets		
Deferred tax and prepayments	839	
Other liabilities		
Deferred tax and deferred income	4 172	–3 333
		57 472
Represented by:		
Debt	30 483	
Provisions	9 472	
Owner's equity	17 517	
		57 472

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When considering MBA's Group Cash Flow Statement (page 5/34), we should start with the cash inflow from operations

1. Profit from Operation
2. Depreciation & Amortization
3. Increase in Provisions
4. Gain/loss on disposal of non-current assets & marketable securities
5. Changes in current assets and liabilities

Cash inflow from operations (Continued)

1. Profit from Operation
2. Depreciation & Amortization
3. Increase in Provisions
4. Gain/loss on disposal of non-current assets & marketable securities
5. Changes in current assets and liabilities

Net profit amounting to €2,222 million, is the bottom number of MBA's income statement

- Starting point
- Adjustments follow

Cash inflow from operations (Continued)

1. Profit from Operation
2. Depreciation & Amortization
3. Increase in Provisions
4. Gain/loss on disposal of non-current assets & marketable securities
5. Changes in current assets and liabilities

Added back to the net profit

As they do not represent cash spent

Cash inflow from operations (Continued)

1. Profit from Operation
2. Depreciation & Amortization
3. Increase in Provisions
4. Gain/loss on disposal of non-current assets & marketable securities
5. Changes in current assets and liabilities

Current year the cash impact of the provision is zero

Increases are added back to net profit

Cash inflow from operations (Continued)

1. Profit from Operation
2. Depreciation & Amortization
3. Increase in Provisions
4. Gain/loss on disposal of non-current assets & marketable securities
5. Changes in current assets and liabilities

MBA is adding back €19 million in the year ended 31 December 20x2

Indicates that a net loss was made on asset disposals

Cash inflow from operations (Continued)

1. Profit from Operation
2. Depreciation & Amortization
3. Increase in Provisions
4. Gain/loss on disposal of non-current assets & marketable securities
5. Changes in current assets and liabilities

Inventories: (Deduct)

MBA has increased its inventory levels by €865 million during 20x2 and this has consumed cash

Receivables: (Add)

In 20x2 MBA reduced its receivables level by €218 million, unlocking valuable cash for its operations

Liabilities: (Add)

MBA has increased its indebtedness to its suppliers during 20x2 by €869 million

Total cash flow from operations for the year 20x2 amounts to €9,311 million, vs. net profit of €2,222 million

Cash is required to purchase new non-current assets and new businesses, also the sale of these produces cash

Cashflow from investments

1. Investments in intangible assets and property, plant and equipment
2. Investment and disposal of leased products
3. Additions to, and payments received on, receivables from sales financing
4. Investment in, and proceeds from, marketable securities

Cash is required to purchase new non-current assets and new businesses (the sale of these produces cash) (Cash outflow from investments)

Cashflow from investments

1. Investments in intangible assets and property, plant and equipment
2. Investment and disposal of leased products
3. Additions to, and payments received on, receivables from sales financing
4. Investment in, and proceeds from, marketable securities

MBA is investing in new non-current assets of over €4,000 million per year

The relatively smaller depreciation charge of €2,675 million indicates an expansion in the asset base

Cash outflow from investments (Continued)

Cashflow from investments

1. Investments in intangible assets and property, plant and equipment

2. Investment and disposal of leased products

Major part of MBA's business comes from leasing its own products rather than selling them outright

3. Additions to, and payments received on, receivables from sales financing

Leasing business is growing since investment figure is larger than the disposal figure

4. Investment in, and proceeds from, marketable securities

Cash outflow from investments (Continued)

Cashflow from investments

1. Investments in intangible assets and property, plant and equipment

2. Investment and disposal of leased products

3. Additions to, and payments received on, receivables from sales financing

4. Investment in, and proceeds from, marketable securities

Significant component of MBA's business model

Net negative impact on cash is only €3691 million

Assuming that MBA charges higher interest on these financing packages than it pays on the money it borrows

Cash outflow from investments (Continued)

Cashflow from investments

1. Investments in intangible assets and property, plant and equipment

2. Investment and disposal of leased products

3. Additions to, and payments received on, receivables from sales financing

4. Investment in, and proceeds from, marketable securities

MBA realized €315 million and re-invested €241 million from this activity during 20x2

The total cash invested in the business for both 20x1 and 20x2 exceeded the cash inflow from operations, thus financing was needed to fund this imbalance

Cashflow from financing

1. Payment of dividend
2. Proceeds from, and the repayment of, bond issues
3. Increase in debt

This part of the cash flow statement records the cash that a company receives from, and pays to, its providers of finance

The total cash invested in the business for both 20x1 and 20x2 exceeded the cash inflow from operations, thus financing was needed for balance

Cashflow from financing

1. Payment of dividend

This cash payment, together with any increase in share price recorded on the stock market, represents the return for shareholders

2. Proceeds from, and the repayment of, bond issues

3. Increase in debt

This part of the cash flow statement records the cash that a company receives from, and pays to, its providers of finance

Cash inflow/outflow from financing activities (Continued)

1. Payment of dividend

2. Proceeds from, and the repayment of, bond issues

Bonds are loans which must be serviced by pre-determined interest to be repaid in due course

MBA has increased its net bond position in both 20x1 and 20x2

3. Increase in debt

Cash inflow/outflow from financing activities (Continued)

1. Payment of dividend

2. Proceeds from, and the repayment of, bond issues

3. Increase in debt

- Normal borrowings from banks
- MBA has increased its borrowings in both years

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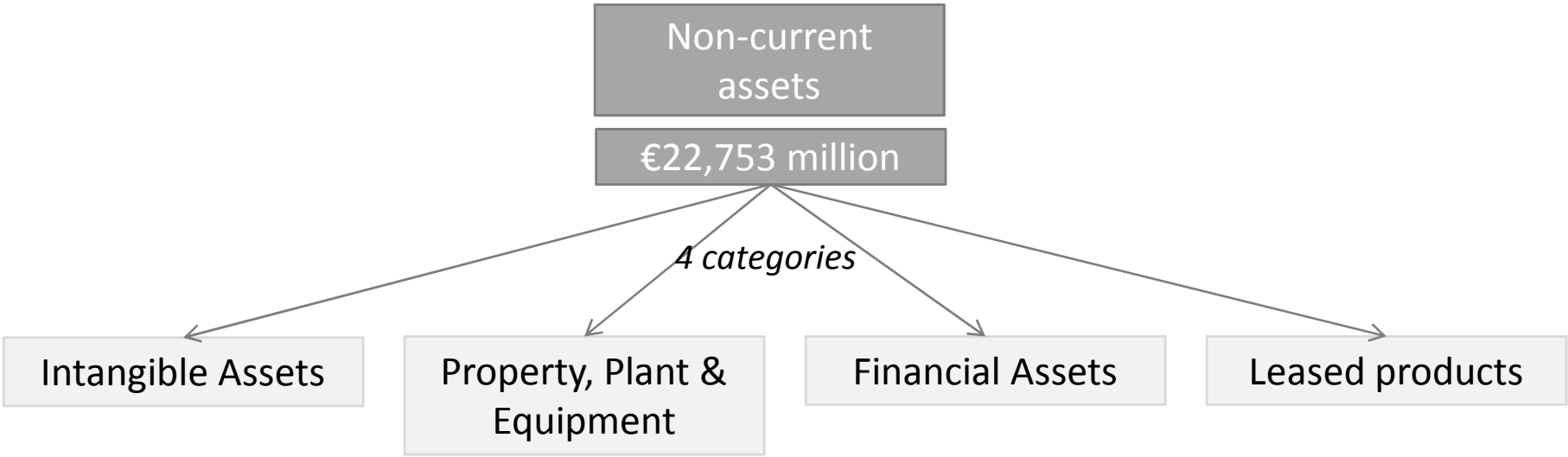
We shall focus on two groups of items to analyze further: non-current assets and depreciation, and inventories

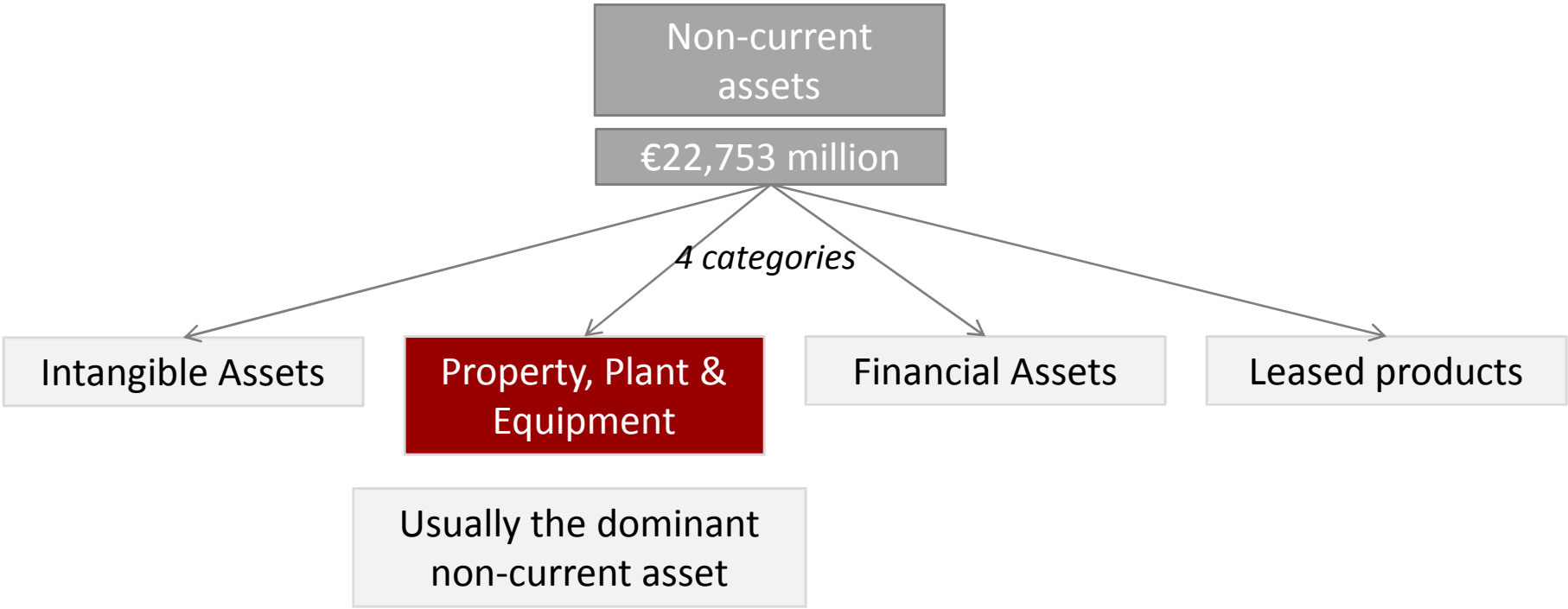
Refer to MBA's non-current assets in Notes 18–21



Note 17 provides a useful overview of all components of non-current assets

We shall focus on two groups of items to discuss in detail: non-current assets and depreciation, and inventories

Refer to MBA's non-current assets in Notes 18–21



Note 17 provides a useful overview of all components of non-current assets

IAS 16 is the principal standard that sets out the measurement and reporting guidance for Property, Plant and Equipment

IAS 16 requires that companies apply one of the two techniques

2 Valuation Techniques For PP&E

Cost less depreciation

Note 6 Accounting Policy:

Shows that the group has selected this technique

Note 17:

- First 6 columns → acquisition and manufacturing cost of assets
- Next 4 columns → depreciation charges
- 1 column → reversals
- Net book value column → acquisition cost less depreciation

Fair value

Is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction

Very difficult to determine for assets that have been purchased or built for the specific requirements of the enterprise

The accounting treatment of assets differs from one item to another depending on how this asset is to be used

To recognize a certain item as PP&E and not an inventory depends on whether it will generate a future economic benefit to the entity or not

Example

1. Major spare engines owned by an airline → PPE
2. Smaller spare parts (seats and interior trim of an aircraft) → Inventory

If a company is building its own asset, it should:

1	***Capitalize*** costs directly attributable to the project, such as own labor, costs of site preparation, initial delivery and handling costs, installation and assembly, testing and professional fees
2	***Capitalize*** the costs of borrowed money (interest) to get the asset into an operational condition ***only*** until the asset is ready for use or sale

Depreciation of PP&E is also governed predominantly by IAS 16

Depreciable Amount of a PP&E = Cost/ Valuation - Estimated Residual Value

- Straight-line Method
- Reducing Balance Method
- Sum-of-the-Units Method

Managers are free to choose the method that suits the operations

IAS 16 requires the method to:

- Reflect the pattern of consumption of the benefits the asset brings over its useful life
- Be applied consistently from year to year

IAS 16 does not require a standard method of depreciation

Let's take one class of PP&E in MBA's Note 17, Plant and machinery, and analyze the year's movements in this heading

in euro million	Acquisition and manufacturing costs						Depreciation and amortisation				Reversals		Net book values	
	1.1.20x2	Translation differences	Additions	Reclassi-fications	Disposals	31.12.20x2	1.1.20x2	Translation differences	Current year	Disposals		31.12.20x2	31.12.20x2	31.12.20x1
Intangible assets	**5 365**	**2**	**1 268**	**–**	**457**	**6 178**	**2 165**	**2**	**708**	**455**	**–**	**2 420**	**3 758**	**3 200**
Land, titles to land, buildings, including buildings on third-party land	4 826	–40	303	497	26	5 560	2 047	–14	153	13	–	2 173	3 387	2 779
Plant and machinery	16 327	–102	2 013	939	714	18 463	11 588	–80	1 589	693	–	12 404	6 059	4 739
Other facilities, factory and office equipment	1 907	–20	250	11	192	1 956	1 409	–15	222	182	–	1 434	522	498
Advance payments made and construction in progress	1 693	2	513	–1 447	4	757	1	–	–	–	–	1	756	1 692
Property, plant and equipment	**24 753**	**–160**	**3 079**	**–**	**936**	**26 736**	**15 045**	**–109**	**1 964**	**888**	**–**	**16 012**	**10 724**	**9 708**

1 Net book value rose during 20x2 from €4,739 million to €6,059 million, ***HOW?***

2 MBA started the year with plant and machinery of original cost €16,327

3 New assets were purchased for €2,013 and assets which originally cost €714 were disposed of, ***totaling €18,463***

4 Depreciation balance of €11,588 is increased by €1,589, then reduced by €693 , ***totaling €12,404***

Because of its potential for profit manipulation, the authors of accounting standards have devoted much attention to the topic

IAS 2 defines inventories:

- Materials or supplies to be consumed in the production process or in the rendering of services
- Assets in the process of production for sale
- Assets held for sale in the ordinary course of business

1. Valuation of inventories is based on the 'lower of cost or market value' rule
2. Net realizable value is the estimated selling price less the estimated costs of completion and the estimated costs necessary to make the sale

Three principal methods are used:

- **FIFO**
- **LIFO**
- **Weighted Average**

What constitutes 'cost' of inventory?

Three such costs:

Storage and Distribution Costs	General and Administrative Overheads	Allocation of Fixed Production Overheads
NOT allowed to be added unless they are necessary in the production process ↓ e.g. the storage of maturing products such as cheese or whisky Distribution costs to customers are also ***NOT*** allowed ↓ As they are Selling costs	***Unlikely*** to be included ↓ They do not contribute to bringing the inventory to its present condition	***Allowed*** provided these costs are based on 'normal' levels of activity

MBA's inventory policy is set out in Note 6 and the components of its inventory are disclosed in Note 22

Note 22 which explains why the stock of finished goods has increased during the year

Inventories comprise the following:

in euro million	31.12.20x2	31.12.20x1
Raw materials and supplies	617	569
Work in progress, unbilled contracts	978	827
Finished goods	3 991	3 439
Goods for resale	881	858
	6 467	5 693

It discloses that a small amount of inventory is valued at net realizable value

It indicates

During the year the selling price of some products had dropped below cost of production

MBA believes that this inventory will sell for at least the net realizable value, otherwise it would write off their whole cost

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Three lessons can be learned from this module

1	Complex & Detailed	Disclosure requirements are numerous, complex and need detailed interpretation by management, accountants, lawyers and auditors
2	Minimum Information Disclosed	A corporate tradition has been built up of disclosing the absolute minimum information required. Very seldom does a company publish information that is not mandatory.
3	Gaps in information	Despite a rigorous application of disclosure requirements, large gaps in information can still be detected by interested readers

→ Would it not be useful to know the breakdown of MBA's manufacturing costs figure of such a magnitude of €24,694 million (given in Note 8)?

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We should appreciate the 6 fundamental accounting principles that support the preparation of annual report and accounts

Fair Presentation

Management to apply accounting policies that:

- Represent faithfully the financial performance (P/L Account) & financial position (B/S)
- Reflect the economic substance of events & transactions and not merely the legal form
- Are neutral, that is free from bias
- Are prudent
- Are complete in all material respects

Going Concern Principle

IAS 1 requires management to make an assessment of the company's ability to continue as a going concern

If management is aware of material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern, these uncertainties should be disclosed

Accrual Basis of Accounting

IAS 1 stipulates that the P/L account and the balance sheet are prepared on accrual basis

↓

When the costs are incurred and the revenues are enjoyed

We should appreciate the 6 fundamental accounting principles that support the preparation of annual report and accounts (continued)

The Consistency Principle

IAS 1 requires entities to stick to their presentation and classification formats from one year to another unless there are compelling reasons to change them

↓

Allow readers to compare this year's performance with the previous year's

Materiality, Aggregation & Offset

IAS 1 requires each material class of similar items to be presented separately & items of a dissimilar nature should be shown separately unless they are immaterial

Offset is the practice of deducting 1 figure from another & publishing net figure

Offsetting isn't allowed if it affects the ability to understand transactions

Profit or Loss for a Period

All items of income & expense recognized in a period should be included in profit and loss

Capital appreciation in non-current assets such as property should also be included

↓

But IAS 16 PP&E reverses this by requiring revaluation gains and losses on property to be taken directly to equity

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Another major force which controls the actions of management is the annual external audit

Auditors	▪ Independent persons who hold an accounting qualification ▪ Recognized by the government ▪ Appointed by the shareholders in general meeting
Role of the Auditor	▪ Required to make a report to the shareholders on the accounts ▪ This report forms part of the published financial statements ▪ Report states whether, in the auditors' opinion, a true and fair view is given of financial performance & of the financial position

Auditors must ensure that the books, records & internal controls have been satisfactorily maintained

Audit Methodology

1. Examination of the system of bookkeeping, accounting and internal control
2. Comparison of the B/S and P/L account with the underlying records
3. Verification of the title, existence and value of the assets appearing in the B/S
4. Verification of the amount of the liabilities appearing in the B/S
5. Verification that the results shown by the P/L account are fairly stated
6. Confirmation that the statutory requirements have been complied with and that relevant accounting standards have been applied correctly

If auditors ensure that the system of internal control is secure, they can rely on that system to provide accurate results

Internal Control

A term used to describe all the various measures taken by the owners and managers of a company to direct and control their employees

Example

A simple but effective method of examining internal control is: ***Flow Charts***

- The auditor draws a flow chart of each major system in the company, purchases, sales, inventory control, cash responsibilities, and so on
- This flow chart will highlight weaknesses in the system where too much authority and executive action resides in one official
- The auditors will then concentrate their attention and tests on this person's activities ensuring that the official has not abused, either deliberately or accidentally, the power vested in him or her by the company
- The auditor will bring this type of shortcoming to management's attention in the end-of-audit letter (sent to the board of directors)

The auditor would look at the following points during the assessment of the system of internal control related to additions to fixed assets

Internal Control Surrounding Additions to Fixed Assets

1. All capital expenditure should be authorized
2. The authorization should be given by means of board minutes or a senior
3. System should provide for the progressing the project and authorizing the necessary payments up to completion (in case of large capital projects)
4. Expenditure capitalized should be for additional assets and not for replacements and should be limited to the cost of work done
5. If capital expenditure is extensive, only a percentage of additions need be verified, but this test should include all items over a stated amount.
6. The items selected for test should be properly authorized, either by the board or by a responsible official
7. Any substantial capital additions that were made during the year should be inspected to ensure that capitalized expenditure is properly represented

If auditors are satisfied with the accuracy & treatment of transactions tested, they can place reliance on the system of internal control

Auditors cannot check every transaction, that's why materiality plays an important role in auditing

Set a limit, usually expressed in monetary terms, below which they will not examine in depth

Called: → Level of Materiality

If mistakes emerge in the low-value transactions, they will not insist on these being put right before signing their audit report

Example

- A brewery company spends about €25 million per annum on repairs and refurbishment of its pubs
- The decision on whether each individual item of expenditure should be capitalized or written off is one which is taken by the company
- But, because the decision affects the level of reported profits the auditor examines these decisions
- But since the €25 million comprises many thousands of individual programs of repairs and refurbishments, he will set a limit of materiality of, say, €50,000
- If he is broadly in agreement with the managerial decisions taken on these, he will assume the smaller items are also correct
- Even if they are wrong, the magnitude of the mistake is not going to make a material difference to the reported results of the company

The aim of the audit report is to enable the auditor to report to the shareholders of the company on the following matters:

1. Whether the accounts give the information required by legislation
2. Whether the B/S gives a true and fair view of the state of the company's affairs as at the end of year
3. Whether the P/L account gives a true and fair view of the profit or loss for the year
4. Whether the group accounts have been properly prepared so as to give a true and fair view of the state of affairs and profit and loss of the company and its subsidiaries

The objective of the auditor should be to convey information and not to arouse enquiry

In addition, auditors must state in their reports if they are unable to satisfy themselves as to the following matters:

1. That they have obtained all the information and explanations which they require
2. That proper books of account have been kept
3. That proper returns adequate for the purpose of their audits have been received from branches or subsidiaries not visited
4. That the accounts are in agreement with the books

The absence of any comment in the audit report means that the auditors are satisfied themselves on the above matters

Two types of audit reports are issued, unqualified and qualified, MBA's audit report was unqualified (Page 5/65)

Unqualified Report

They have found ***nothing*** wrong in the audit

Accounts show a true and fair view of the state of affairs of the company

Qualified Report

They have found ***something*** wrong in the audit

Auditors should state

- Specifically & positively the reason behind it
- The extent to which, the auditor is not satisfied
- The effect on the accounts & the amounts involved

Example

Auditors may be unhappy about the provision for bad and doubtful debts. The report would read as follows:

> In our opinion, the provision which has been made by the company for losses in respect of bad and doubtful is insufficient by €6 million. With this reservation in our opinion the accounts set out on pages X to Y give a true and fair view. . .