The Institute of Chartered Accountants in England and Wales

FINANCIAL ACCOUNTING AND REPORTING

For exams in 2016

Study Manual

www.icaew.com
Welcome to ICAEW

I am delighted that you have chosen ICAEW to progress your journey towards joining the chartered accountancy profession. It is one of the best decisions I also made.

The role of the accountancy profession in the world’s economies has never been more important. People making financial decisions need knowledge and guidance based on the highest technical and ethical standards. ICAEW Chartered Accountants provide this better than anyone. They challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity all over the world.

As a world leader of the accountancy and finance profession, we are proud to promote, develop and support over 144,000 chartered accountants worldwide. Our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. They are part of something special, and now, so are you. It’s with our support and dedication that our members and hopefully yourself, will realise career ambitions, maintain a professional edge and contribute to the profession.

You are now on your journey towards joining the accountancy profession, and a highly rewarding career with endless opportunities. By choosing to study for our world-leading chartered accountancy qualification, the ACA, you too have made the first of many great decisions in your career.

You are in good company, with a network of over 26,000 students around the world made up of like-minded people, you are all supported by ICAEW. We are here to support you as you progress through your studies and career: we will be with you every step of the way, visit page x to review the key resources available as you study.

I wish you the best of luck with your studies and look forward to welcoming you to the profession in the future.

Michael Izza
Chief Executive
ICAEW
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1 Introduction

ACA qualification

The ICAEW chartered accountancy qualification, the ACA, is a world-leading professional qualification in accountancy, finance and business.

The ACA has integrated components that give you an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAEW Chartered Accountant.

Each component is designed to complement each other, which means that you can put theory into practice and you can understand and apply what you learn to your day-to-day work. Progression through all the elements of the ACA simultaneously will enable you to be more successful in the workplace and exams.

The components are:

- Professional development
- Ethics and professional scepticism
- 3-5 years practical work experience
- 15 accountancy, finance and business modules

To find out more on the components of the ACA and what is involved in training, visit your dashboard at icaew.com/dashboard.
2 Financial Accounting and Reporting

The full syllabus and technical knowledge grids can be found within the module study guide. Visit icaew.com/dashboard for this and more resources.

2.1 Module aim

To enable candidates to prepare complete single entity and consolidated financial statements, and extracts from those financial statements, covering a wide range of International Financial Reporting Standards (IFRS).

Candidates will also be required to explain accounting and reporting concepts and ethical issues, and the application of IFRS to specified single entity or group scenarios.

On completion of this module, students will be able to:

- Explain the contribution and inherent limitations of financial statements, apply the International Accounting Standards Board’s (IASB) conceptual framework for financial reporting and identify and explain key ethical issues
- Prepare and present financial statements from accounting data for single entities, whether organised in corporate or in other forms, in conformity with IFRS and explain the application of IFRS to specified single entity scenarios
- Identify the circumstances in which entities are required to present consolidated financial statements, prepare and present them in conformity with IFRS and explain the application of IFRS to specified group scenarios.

2.2 Method of assessment

The Financial Accounting and Reporting module will be 3 hours long containing four written test questions. Candidates may use the IASB’s IFRS open book text.

The module will include questions on:

(a) Preparation of single entity financial statements (excluding statement of cash flows) from trial balance or draft financial statements;
(b) Preparation of consolidated financial statements (excluding consolidated statement of cash flows) from individual financial statements or draft consolidated financial statements; and
(c) Explanation of the application of IFRS to specified scenarios.

Other question types could include:

(a) Preparation of consolidated statement of cash flow, or extracts therefrom, from consolidated financial statements or draft consolidated statement of cash flow; and
(b) Mixed or single topic questions requiring extracts from single entity or consolidated financial statements (including from statement of cash flows) and/or explanation of accounting treatment with supporting calculations.

Concepts and ethics will be tested in any of the written test questions.

2.3 Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

<table>
<thead>
<tr>
<th>Syllabus area</th>
<th>Weighting (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Accounting and reporting concepts and ethics</td>
<td>10</td>
</tr>
<tr>
<td>2 Single entity financial statements</td>
<td>60</td>
</tr>
<tr>
<td>3 Consolidated financial statements</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>
3 Permitted Texts

At the Professional and Advanced Levels there are specific texts that you are permitted to take into your exams with you. All information for these texts, the editions that are recommended for your examinations and where to order them from, is available on www.icaew.com/permittedtexts.

<table>
<thead>
<tr>
<th>Professional Level Examinations</th>
<th>Permitted Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit and Assurance</td>
<td>✓</td>
</tr>
<tr>
<td>Financial Accounting and Reporting</td>
<td>✓</td>
</tr>
<tr>
<td>Tax Compliance</td>
<td>✓</td>
</tr>
<tr>
<td>Business Strategy</td>
<td>✗</td>
</tr>
<tr>
<td>Financial Management</td>
<td>✗</td>
</tr>
<tr>
<td>Business Planning: Banking/Insurance/Taxation</td>
<td>No restrictions</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Advanced Level Examinations</th>
<th>Permitted Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Reporting</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Strategic Business Management</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Case Study</td>
<td>No restrictions</td>
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</tbody>
</table>

Business Planning: Banking/Insurance/Taxation and the Advanced Level exams have no restrictions so you may take any hard copy materials in to these exams that you wish, subject to practical space restrictions.

Although the examiners use the specific editions listed to set the assessment, you may use a different edition of the text at your own risk. If you use a different edition within your exams, you should note this inside your answer booklet, at the beginning of the question.

This information, as well as what to expect and what is and is not permitted in your exams is available in the Instructions to Candidates. You will be sent this with your exam admission details and it is also available on our website; www.icaew.com/exams.
4 Key Resources

Student support team
Our student support team are here to help you as much as possible, providing full support throughout your studies.

T +44 (0)1908 248 250
F +44 (0)1908 248 069
E studentsupport@icaew.com

Student website
The student area of our website provides the latest information, guidance and exclusive resources to help you progress through the ACA. Find everything you need (from sample papers to errata sheets) at icaew.com/dashboard.

Online student community
The online student community provides support and practical advice – wherever you are, whenever you need it. With regular blogs covering a range of work, life and study topics as well as a forum where you can post your questions and share your own tips. Join the conversation at icaew.com/studentcommunity.

Tuition
The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are receiving structured tuition with an ICAEW Partner in Learning, make sure you know how and when you can contact your tutors for extra help. If you are not receiving structured tuition and are interested in classroom, online or residential learning, take a look at our recognised Partner in Learning tuition providers in your area, on our website icaew.com/dashboard.

Faculties and Special Interest Groups
Faculties and special interest groups support and develop members and students in areas of work and industry sectors that are of particular interest.

Our seven faculties provide knowledge, events and essential technical resources. Register to receive a complimentary e-magazine from one faculty of your choice each year throughout your studies.

Our 12 special interest groups provide practical support, information and representation within a range of industry sectors. Register to receive free provisional membership of one group each year throughout your studies.

Find out more about faculties and special interest groups at icaew.com/facultiesandsigs.

The Library & Information Service
The Library & Information Service is ICAEW’s world-leading accountancy and business library.

The library provides access to thousands of resources online and a document delivery service, you’ll be sure to find a useful eBook, relevant article or industry guide to help you. Find out more at icaew.com/library.
CHAPTER 1

Reporting framework and ethics

Introduction
Examination context

Topic List
1 Financial statements
2 Purpose and use of financial statements
3 Bases of accounting
4 The IASB Conceptual Framework
5 The regulatory framework
6 Convergence process
7 Inherent limitations of financial statements
8 Not-for-profit entities
9 Ethical and professional issues

Summary and Self-test
Technical reference
Answers to Interactive questions
Answers to Self-test
Introduction

Learning objectives

- Explain the nature of financial reporting and objectives of financial statements
- Explain the standard-setting process used by national and international bodies (IASB) and the authority of the national and international standards, using appropriate examples as an illustration
- Explain, in non-technical language and with appropriate examples, the current work to achieve convergence between UK GAAP and international reporting standards
- Apply the principles of the IASB Conceptual Framework, including the qualitative characteristics of financial information, the elements of financial statements, recognition and measurement of the elements
- Explain and demonstrate the differences between financial statements produced using the accrual basis, cash accounting and the break-up basis
- Discuss the concepts of ‘fair presentation’ and ‘true and fair view’ and the circumstances in which these concepts may override the detailed provisions of legislation or of accounting standards
- Explain the regulatory framework affecting not-for-profit entities
- Recognise the ethical and professional issues for a professional accountant undertaking work in and giving advice on accounting and financial reporting: explain the relevance and importance of these issues and evaluate the relative merits of different standpoints taken in debate

Specific syllabus references for this chapter are: 1a, 1b, 1c, 1d, 1e, 1f, 1g, 1i, 2g.

Syllabus links

The issues covered by this chapter and particularly the principles introduced by the IASB Conceptual Framework are a fundamental part of the Financial Accounting and Reporting syllabus.

This chapter takes your knowledge of current issues and particularly the progress of the convergence process which aims to produce a set of global accounting standards much further. These are areas which are also likely to be highly relevant at the Advanced Stage. The ethical considerations at the end of the chapter are dealt with specifically here but will be pervasive across all areas of the syllabus.

Examination context

Accounting and reporting concepts constitute 10% of the syllabus. In the examination, candidates may be required to:

- Discuss the purpose of accounting regulations and standards for both profit-making and not-for-profit entities
- Explain, with examples, the objectives and limitations of financial statements
- Explain the qualitative characteristics of financial information and the constraints on such information
- Describe the financial effects of the application of the definitions of the IASB Conceptual Framework
- Perform simple calculations to demonstrate the difference between the accrual basis, cash accounting and the break-up basis
- Discuss and comment on the convergence process, including recent developments
- Identify and explain the ethical and professional issues for a professional accountant
1 Financial statements

Section overview
- In the UK all companies must comply with the provisions of the Companies Act.
- In the UK financial statements must be prepared in accordance with either UK GAAP or IFRS. They must also give a true and fair view.

1.1 What is financial reporting?

Financial reporting is the process of identifying, measuring and communicating economic information to others so that they may make decisions on the basis of that information and assess the stewardship of the entity’s management.

Financial reporting involves:
- Recording transactions undertaken by a business entity.
- Grouping similar transactions together which are appropriate to the business.
- Presenting periodic results.

The Financial Accounting and Reporting syllabus focuses on the preparation of published financial information. Typically, this information is made available annually or half-yearly (sometimes quarterly) and is presented in formats laid down or approved by governments in each national jurisdiction. (The Advanced syllabus deals with more complex reporting issues and analysis and interpretation.)

By contrast, management accounting or reporting is internal reporting for the use of the management of a business itself. Internal management information can be tailored to management’s own needs and provided in whatever detail and at whatever frequency (e.g. continuous real-time information) management decides is best suited to the needs of their business.

General principles relating to financial reporting are set out in the IASB Conceptual Framework for Financial Reporting (Conceptual Framework), which is explained further below.

1.2 Entity

Most accounting requirements are written with a view to use by any type of accounting entity, including companies and other forms of organisation, such as a partnership. In this text, the term ‘company’ is usually used, because the main focus of the Financial Accounting and Reporting syllabus is on the accounts of companies and groups of companies.

1.3 Financial statements

The principal means of providing financial information to external users is the annual financial statements. Financial statements provide a summary of the performance of an entity over a particular period and of its position at the end of that period.

A complete set of financial statements prepared under IFRS comprises:
- The statement of financial position.
- The statement of profit or loss and other comprehensive income or two separate statements being the statement of profit or loss and the statement of other comprehensive income (statements of financial performance).
- The statement of changes in equity (another statement of financial performance).
- The statement of cash flows.
- Notes to the financial statements.

The notes to the financial statements include:
- Accounting policies, i.e. the specific principles, conventions, rules and practices applied in order to reflect the effects of transactions and other events in the financial statements.
- Detailed financial and narrative information supporting the information in the primary financial statements.
- Other information not reflected in the financial statements, but which is important to users in making their assessments.

The individual elements that are included in the financial statements are covered in detail later in this chapter.

1.4 Requirement to produce financial statements

Limited liability companies are required by law to prepare and publish financial statements annually. The form and content may be regulated primarily by national legislation, and in most cases must also comply with Financial Reporting Standards.

In the UK, all companies must comply with the provisions of the Companies Act 2006 (CA 2006). The key impact of this is as follows:

- Every UK registered company is required to prepare financial statements for each financial year which give a true and fair view.
- The individual (and some group) financial statements may be prepared:
  - In accordance with the CA 2006 (as regards format and additional information provided by way of notes), or
  - In accordance with international accounting standards.

1.5 Filing deadlines

Legal regulations concerning the financial statements of an entity are of course specific to the country of incorporation. UK companies come under the Companies Act 2006.

The Companies Act establishes deadlines for the filing of financial statements:

- Private companies: nine months after the financial year end
- Public companies: six months after the financial year end

Listed companies are required by the Financial Conduct Authority to file their financial statements within four months of the financial year end.

1.6 Financial reporting standards

Company financial statements must also comply with relevant Financial Reporting Standards and other professional guidance. In the UK these are as follows.

- **Accounting Standards**
  
  The new UK accounting standards are:
  
  FRS 102 The Financial Reporting Standard Applicable in the UK and Republic of Ireland
  
  FRS 101 Reduced Disclosure Framework
  
  These are explained more fully later in this chapter.

- **Financial Reporting Standard for Smaller Entities (FRSSE)**
  
  This brings together all the accounting guidance which UK small companies are required to follow in drawing up their financial statements.

- **International Financial Reporting Standards (IFRS)**
  
  These are issued by the International Accounting Standards Board (IASB). UK companies whose securities are traded in a regulated public market, eg the London Stock Exchange, must prepare their group accounts in accordance with IFRS.

  These learning materials assume the preparation of financial statements in accordance with IFRS.
Unincorporated entities are exempt from the above requirements but may need to follow other regulation, eg charities must comply with the Charities Act. Incorporated charities must prepare their financial statements in accordance with the CA 2006 (ie the IFRS option is not open to them).

Point to note

The term UK Generally Accepted Accounting Practice (GAAP) refers to all the rules, from whatever source, which govern UK accounting. In the UK this is seen primarily as a combination of:

- **Company law** (mainly CA 2006 – see Section 1.4)
- **Accounting Standards**
- **Stock Exchange requirements** (These are not examinable in the syllabus)

In the UK, GAAP has no statutory or regulatory authority or definition (unlike some other countries such as the United States) although the use of the term is increasingly common in practice.

1.7 Fair presentation

IA5 1 Presentation of Financial Statements requires financial statements to 'present fairly' the financial position and performance of an entity.

'Present fairly' is explained as representing faithfully the effects of transactions. In general terms this will be the case if IFRS are adhered to. IAS 1 states that departures from international standards are only allowed:

- In extremely rare cases.
- Where compliance with IFRS would be so misleading as to conflict with the objectives of financial statements as set out in the Conceptual Framework, that is to provide information about financial position, performance and changes in financial position that is useful to a wide range of users.

1.8 True and fair view

In the UK there is an overriding Companies Act requirement that financial statements should present a true and fair view. This term is not defined in the Companies Act or Accounting Standards.

Truth is usually seen as an objective concept reflecting factual accuracy within the bounds of materiality.

Fairness is usually seen as meaning that the view given is objective and unbiased.

True and fair is usually defined in terms of GAAP. This means:

- **Compliance with Accounting Standards** (which can be overridden on true and fair grounds only very rarely)
- **Adherence to the requirements of the Companies Act 2006**, including its true and fair override (see below)
- In the absence of more specific requirements, **application of general accounting principles and fundamental concepts** and, where appropriate, adherence to accepted industry practices

Points to note

- The CA 2006 uses the term 'a true and fair view' rather than 'the true and fair view' because it is possible for there to be more than one true and fair view. For example, financial statements based on historical cost can be true and fair, as can financial statements which incorporate revaluations.
- What constitutes a true and fair view can then be restricted by stating that where a choice of treatments or methods is permitted, the one selected should be the most appropriate to the company’s circumstances. This restriction is likely to ensure compliance with the spirit and underlying intentions of requirements, not just with the letter of them.
- A further restriction is that financial statements should reflect the economic position of the company, thereby reflecting the **substance of transactions** (ie commercial reality), not merely their legal form. In most cases this will be achieved by adhering to GAAP.
1.9 The statutory ‘true and fair override’

The CA 2006 requires that where compliance with its accounting rules would not lead to a true and fair view, **those rules should be departed from** to the extent necessary to give a true and fair view.

Where the override of the statutory accounting requirements is invoked, eg to comply with an accounting standard, **the Act requires disclosure** of the particulars of the departure, the reason for it, and the financial effect.

The CA 2006 also states that where compliance with its disclosure requirements is insufficient to give a true and fair view, **additional information should be disclosed** such that a true and fair view is provided.

1.10 Comparison of UK GAAP and IFRS

As ‘fair presentation’ is explained as representing faithfully the effects of transactions, there is unlikely to be any substantial difference in practical terms between it and the true and fair concept.

Because international standards are designed to operate in all legal environments, they cannot provide for departures from the legal requirements in any particular country. IAS 1 indicates that there are few, if any, circumstances where compliance with IFRS will be fundamentally misleading. In effect, UK companies applying IFRS cannot take advantage of the true and fair override.

Companies reporting under FRS 101 or FRS 102 are however reporting under the Companies Act, so the true and fair override is still available to them.

1.11 Judgements and financial statements

Although IFRS narrow down the range of acceptable alternative accounting treatments, there are still many areas which are left to the discretion of the directors of the company. On the whole, the concept of faithful representation should result in transactions being ‘presented fairly’. However, commercial and financial considerations may result in pressure being brought to bear to account for and report transactions in accordance with their strict legal form. This can raise ethical questions for a professional accountant.

2 Purpose and use of financial statements

**Section overview**

- Financial statements are used to make economic decisions by a wide range of users.
- All users require information regarding:
  - Financial position
  - Financial performance
  - Changes in financial position

2.1 Users and their information needs

The form and content of financial statements must be influenced by the use to which they are put. The IASB Conceptual Framework emphasises that financial statements are used to make economic decisions, such as:

- To decide when to **buy, hold or sell an equity investment**
- To assess the **stewardship or accountability of management**
- To assess an entity’s ability to pay and **provide other benefits to employees**
- To assess **security** for amounts lent to the entity
- To determine **taxation policies**
- To determine **distributable profits and dividends**
- To prepare and use **national income statistics**
- To **regulate** the activities of entities
Much of the information needed for these different decisions is in fact common to them all. Financial statements aimed at meeting these common needs of a wide range of users are known as ‘general purpose’ financial statements.

We can identify the following users of financial statements and their specific information needs.

<table>
<thead>
<tr>
<th>Users</th>
<th>Need information to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present and potential investors</td>
<td>• Make investment decisions, therefore need information on:</td>
</tr>
<tr>
<td></td>
<td>– Risk and return on investment</td>
</tr>
<tr>
<td></td>
<td>– Ability of entity to pay dividends</td>
</tr>
<tr>
<td>Employees</td>
<td>• Assess their employer's stability and profitability</td>
</tr>
<tr>
<td></td>
<td>• Assess their employer’s ability to provide remuneration, employment opportunities and retirement and other benefits</td>
</tr>
<tr>
<td>Lenders</td>
<td>• Assess whether loans can be repaid, and related interest can be paid, when due</td>
</tr>
<tr>
<td>Suppliers and other trade payables</td>
<td>• Assess the likelihood of being paid when due</td>
</tr>
<tr>
<td>Customers</td>
<td>• Assess whether the entity will continue in existence – important where customers have a long-term involvement with, or are dependent on, the entity, eg where there are product warranties or where specialist parts may be needed</td>
</tr>
<tr>
<td>Governments and their agencies</td>
<td>• Assess allocation of resources and, therefore, activities of entities</td>
</tr>
<tr>
<td></td>
<td>• Assist in regulating activities</td>
</tr>
<tr>
<td></td>
<td>• Assess taxation</td>
</tr>
<tr>
<td></td>
<td>• Provide a basis for national statistics</td>
</tr>
<tr>
<td>The public</td>
<td>• Assess trends and recent developments in the entity's prosperity and its activities – important where the entity makes a substantial contribution to a local economy, eg by providing local employment and using local suppliers</td>
</tr>
</tbody>
</table>

In most cases the users will need to analyse the financial statements in order to obtain the information they need. This might include the calculation of accounting ratios. (The calculation of accounting ratios and the analysis of those ratios is covered in the Advanced syllabus.)

2.2 Objective of financial statements

The objective of financial statements is to provide information about the reporting entity’s financial position and financial performance that is useful to a wide range of users in making economic decisions.

This objective can usually be met by focusing exclusively on the information needs of present and potential investors. This is because much of the financial information that is relevant to investors will also be relevant to other users.

In the UK equivalent of the IASB Conceptual Framework – the ASB’s Statement of Principles – investors and potential investors are described as ‘the defining class of user’.

2.3 Accountability of management

Management also has a stewardship role, in that it is accountable for the safe-keeping of the entity’s resources and for their proper, efficient and profitable use. Providers of risk capital are interested in information that helps them to assess how effectively management has fulfilled this role, but again this assessment is made only as the basis for economic decisions, such as those about investments and the reappointment/replacement of management.

It is also the case that in a smaller entity the owner and manager can be the same individual.
Financial reporting helps management to meet its need to be accountable to shareholders, and also to other stakeholders (e.g., employees or lenders), by providing information that is useful to the users in making **economic decisions**.

However, financial statements cannot provide the complete set of information required for assessing the stewardship of management (see Section 7 'Inherent limitations of financial statements' later in this chapter).

### 2.4 Financial position, performance and changes in financial position

All economic decisions are based on an evaluation of an entity's ability to generate cash and of the timing and certainty of its generation. Information about the entity's financial position, performance and changes in financial position provides the foundation on which to base such decisions.

#### 2.4.1 Financial position

An entity's financial position covers:

- **The economic resources** it controls
- Its **financial structure** (i.e., debt and share finance)
- Its **liquidity and solvency** and
- Its **capacity to adapt to changes** in the environment in which it operates

Investors require information on financial position because it helps in assessing:

- The entity's ability to **generate cash in the future**.
- How **future cash flows will be distributed** among those with an interest in, or claims on, the entity.
- Requirements for **future finance** and ability to raise that finance.
- The ability to meet **financial commitments** as they fall due.

Information about financial position is primarily provided in a **statement of financial position**.

#### 2.4.2 Financial performance

The profit earned in a period is used as the measure of financial performance, where profit is calculated as income less expenses. Information about performance and variability of performance is useful in:

- Assessing **potential changes in the entity's economic resources** in the future
- Predicting the entity's **capacity to generate cash** from its existing resource base, and
- Forming judgements about the effectiveness with which additional resources might be employed.

Information on financial performance is provided by:

- The **statement of profit or loss and other comprehensive income** and/or **statement of profit or loss**.
- The **statement of changes in equity**.

#### 2.4.3 Changes in financial position

Changes in financial position can be analysed under the headings of **investing**, **financing** and **operating activities** and are presented in a **statement of cash flows**.

Cash flow information is largely free from the more **judgemental allocation and measurement issues** (i.e., in which period to include things and at what amount) that arise when items are included in the statement of financial position or performance statements. For example, depreciation of non-current assets involves judgement and estimation as to the period over which to charge depreciation. Cash flow information excludes non-cash items such as depreciation.

Cash flow information is therefore seen as being **factual in nature**, and hence more reliable than other sources of information.
Information on the generation and use of cash is useful in evaluating the entity’s ability to generate cash and its need to use what is generated.

2.4.4 Notes and supplementary schedules

Notes and schedules attached to financial statements can provide additional information relevant to users, for example the non-current assets note (see Chapter 2).

3 Bases of accounting

Section overview

- There are three bases of accounting which you need to be familiar with:
  - Accrual basis
  - Cash basis
  - Break-up basis
- The going concern basis is referred to by the IASB’s Conceptual Framework as the ‘underlying assumption’.

3.1 Accrual basis

Under this basis of accounting, transactions are recognised when they occur, not when the related cash flows into or out of the entity. You will be familiar with this basis from your Accounting studies. Examples of the importance of this basis are as follows:

- Sales are recorded in the period in which the risks and rewards of ownership pass from seller to buyer, not when the seller receives full payment. While this basis has no effect on the timing of the recognition of cash sales, it does mean that credit sales are recorded earlier than if the cash basis of accounting was used. When credit sales are recognised, a receivable is set up in the entity’s books.
- Expenses are recognised in the period when the goods or services are consumed, not when they are paid for. An amount payable will be set up in the entity’s books for credit purchases, again leading to earlier recognition than if the cash basis was used.
- The consumption of non-current assets, such as plant and machinery, is recognised over the period during which they are used by the entity (ie the asset is depreciated), not in the year of purchase as they would be under the cash basis of accounting.

Financial statements prepared on this basis provide information both about past transactions involving cash and about future resources flowing into the entity (when customers pay up) and flowing out of it (when suppliers are paid). They are therefore more useful for the making of economic decisions than those produced on the cash basis.

The IASB’s Conceptual Framework makes it clear that information in an entity’s financial statements should be prepared on the accrual basis.

3.2 Going concern basis

The accrual basis of accounting assumes that an entity is a going concern. Under this basis, financial statements are prepared on the assumption that the entity will continue in operation for the foreseeable future, in that management has neither the intention nor the need to liquidate the entity by selling all its assets, paying off all its liabilities and distributing any surplus to the owners. Examples of the importance of this basis are as follows:

- The measurement of receivables from trade customers is made on the basis that there is no time limit over which management will chase slow payers. If the entity were to cease operation in, say, three months, a number of balances might have to be regarded as bad (irrecoverable) debts.
- The measurement of non-current assets is made on the basis that they can be utilised throughout their planned life. Otherwise, they would have to be valued at what they could immediately be...
sold for, which might not be very much, in the case of assets used in markets where there is excess capacity.

Going concern is referred to by the IASB’s Conceptual Framework as the ‘underlying assumption’.

### 3.3 Cash basis

The cash basis of accounting is not used in the preparation of a company statement of financial position and performance statements as it is not allowed by IFRS or UK GAAP, although the cash effect of transactions is presented in the form of a statement of cash flows. (We will look at the statement of cash flows in Chapter 2.) The cash basis may be used, however, for small unincorporated entities, for example clubs and societies.

In many ways the cash basis of accounting is very simple. Only the cash impact of a transaction is recorded. Examples of the impact of this are as follows:

- **Sales** are recorded in the period in which the seller receives full payment. For credit sales this will delay the recognition of the transaction.
- **Purchases** are recorded in the period in which goods are paid for rather than the period in which the goods are purchased. For credit purchases this will delay the recognition of the purchase.
- **The purchase of a capital asset** is treated as a cash outflow at the point that the cash consideration is paid. No subsequent adjustment is made for depreciation as this has no impact on the cash balance of the business.

### Worked example: Comparison of accrual basis and cash basis

Joe Co buys 100 T-shirts in January at £3.50 each. The purchase is made for cash. During January 30 T-shirts are sold for cash at £7.00 each.

Using accrual based accounting the results for January would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong> (30 × £7)</td>
<td>210</td>
<td></td>
</tr>
<tr>
<td><strong>Cost of sales</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases (100 × £3.50)</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>Closing inventory (70 × £3.50)</td>
<td>(245)</td>
<td></td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td>(105)</td>
<td>105</td>
</tr>
</tbody>
</table>

Using cash accounting the results for January would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong> (30 × £7)</td>
<td>210</td>
</tr>
<tr>
<td><strong>Cost of sales</strong></td>
<td>(350)</td>
</tr>
<tr>
<td><strong>Loss</strong></td>
<td>(140)</td>
</tr>
</tbody>
</table>

Notice that there is an overall loss of £140 using cash accounting even though there is a profit for the month of £105 using the accrual basis. The difference of £245 is the value of the closing inventories which is carried forward as an asset under the accruals basis.

### 3.4 Break-up basis

As we saw in Section 3.1 one of the key assumptions made under the accruals basis is that the business will continue as a going concern. However, this will not necessarily always be the case. There may be an intention or need to sell off the assets of the business. Such a sale typically arises where the business is in financial difficulties and needs the cash to pay its creditors. Where this is the case an alternative method of accounting must be used (in accordance with IAS 1 Presentation of Financial Statements). In these circumstances the financial statements will be prepared on a basis other than going concern, which is commonly referred to as the ‘break-up’ basis. The break-up basis values assets and liabilities today as if the entity was about to cease trading and had to dispose of all its assets and liabilities.

The effect of this is seen primarily in the statement of financial position as follows:


- **Classification of assets**
  All assets and liabilities would be classified as **current** rather than non-current.

- **Valuation of assets**
  Assets would be valued on the basis of the recoverable amount on sale. This is likely to be substantially lower than the carrying amount of assets held under historical cost accounting.

4 The IASB Conceptual Framework

**Section overview**

The IASB Framework for the Preparation and Presentation of Financial Statements was the conceptual framework upon which all IASs and IFRSs were based up to 2010. It is gradually being replaced by the Conceptual Framework for Financial Reporting. The extant framework determines:

- How financial statements are prepared
- The information they contain

4.1 Conceptual Framework

The IASB Framework for the Preparation and Presentation of Financial Statements was produced in 1989 and has been gradually replaced by the new Conceptual Framework for Financial Reporting. This was the result of an IASB/FASB joint project to be carried out in phases. The first phase, comprising Chapters 1 and 3, was published in September 2010. Chapter 2 entitled ‘The reporting entity’ has not yet been published. The current version of the Conceptual Framework includes the remaining chapters of the 1989 Framework as Chapter 4.

The Conceptual Framework for Financial Reporting is currently as follows:

Chapter 1: The objective of general purpose financial reporting
Chapter 2: The reporting entity (to be issued)
Chapter 3: Qualitative characteristics of useful financial information
Chapter 4: Remaining text of the 1989 Framework:

- Underlying assumption
- The elements of financial statements
- Recognition of the elements of financial statements
- Measurement of the elements of financial statements
- Concepts of capital and capital maintenance

In this chapter we have already introduced some of the concepts dealt with by the Conceptual Framework.

We will now look specifically at each section in turn.

4.2 Introduction to the Conceptual Framework

The Introduction provides a list of the purposes of the Conceptual Framework:

(a) To assist the Board in the development of future IFRSs and in its review of existing IFRSs.
(b) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs.
(c) To assist national standard-setting bodies in developing national standards.
(d) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.
(e) To assist auditors in forming an opinion as to whether financial statements comply with IFRSs.
(f) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs.

(g) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

The Conceptual Framework is not an IFRS and so does not overrule any individual IFRS. In the (rare) case of conflict between an IFRS and the Conceptual Framework, the IFRS will prevail.

4.3 Chapter 1: The objective of general purpose financial reporting

The Conceptual Framework states that:

‘The objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.’

These users need information about:

- The economic resources of the entity;
- The claims against the entity; and
- Changes in the entity’s economic resources and claims

Information about the entity’s economic resources and the claims against it helps users to assess the entity’s liquidity and solvency and its likely needs for additional financing.

Information about a reporting entity’s financial performance (the changes in its economic resources and claims) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

The Conceptual Framework makes it clear that this information should be prepared on an accruals basis.

Information about a reporting entity’s cash flows during a period also helps users assess the entity’s ability to generate future net cash inflows and gives users a better understanding of its operations.

4.4 Chapter 3: Qualitative characteristics of useful financial information

4.4.1 Overview

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.

The two fundamental qualitative characteristics are relevance and faithful representation.

There are then four enhancing qualitative characteristics which enhance the usefulness of information that is relevant and faithfully represented. These are: comparability, verifiability, timeliness and understandability.
The key issues can be summarised as follows:

![Diagram of qualitative characteristics and enhancing characteristics]

**4.4.2 Relevance**

Relevant financial information can be of **predictive value**, **confirmatory value** or both. These roles are interrelated.

**Definition**

Relevance: Relevant financial information is capable of making a difference in the decisions made by users.

Information on financial position and performance is often used to predict future position and performance and other things of interest to the user, e.g., likely dividend, wage rises. The **manner of presentation** will enhance the ability to make predictions, e.g., by highlighting unusual items.

The relevance of information is affected by its **nature and its materiality**.

**Definition**

Materiality: Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

Information may be judged relevant simply because of its nature (e.g., remuneration of management). In other cases, both the nature and materiality of the information are important. Materiality is not a qualitative characteristic itself (like relevance or faithful representation), because it is merely a threshold or cut-off point.

**4.4.3 Faithful representation**

Financial reports represent **economic phenomena** in words and numbers. To be useful, financial information must not only represent relevant phenomena but must faithfully represent the phenomena that it purports to represent. The user must be able to depend on it being a **faithful representation**.
**Definition**

**Faithful representation:** A perfectly faithful representation should be **complete, neutral and free from error.**

A **complete** depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A **neutral** depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.

**Free from error** means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

**Substance over form**

This is **not a separate qualitative characteristic** under the Conceptual Framework. The IASB says that to do so would be redundant because it is **implied in faithful representation.** Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality.**

**Definition**

**Substance over form:** The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Most transactions are reasonably straightforward and their substance, ie commercial effect, is the same as their strict legal form. However, in some instances this is not the case as can be seen in the following worked example.

**Worked example: Sale and repurchase agreement**

A Ltd sells goods to B Ltd for £10,000, but undertakes to repurchase the goods from B Ltd in 12 months' time for £11,000.

The legal form of the transaction is that A has sold goods to B as it has transferred legal title. To reflect the legal form, A Ltd would record a sale and show the resulting profit, if any, in profit or loss for the period. In 12 months' time when legal title is regained, A Ltd would record a purchase. There would be no liability to B Ltd in A Ltd’s statement of financial position until the goods are repurchased.

The above treatment does not provide a faithful representation because it does not reflect the economic substance of the transaction. After all, A Ltd is under an obligation from the outset to repurchase the goods and A Ltd bears the risk that those goods will be obsolete and unsaleable in a year’s time.

The substance is that B Ltd has made a secured loan to A Ltd of £10,000 plus interest of £1,000. To reflect substance, A Ltd should continue to show the goods as an asset in inventories (at cost or net realisable value, if lower) and should include a liability to B Ltd of £10,000 in payables. A Ltd should accrue for the interest over the duration of the loan.

When A Ltd pays £11,000 to regain legal title, this should be treated as a repayment of the loan plus accrued interest.

Other examples of accounting for substance:

- **Leases**
  
  Accounting for finance leases under IAS 17 *Leases* (which is covered in Chapter 7) is an example of the application of substance as the lessee includes the asset in its statement of financial position even though the legal form of a lease is that of renting the asset, not buying it.
4.4.4 Enhancing qualitative characteristics

Comparability

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Consistency, although related to comparability, is not the same. It refers to the use of the same methods for the same items (ie consistency of treatment) either from period to period within a reporting entity or in a single period across entities.

The disclosure of accounting policies is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

Comparability is not the same as uniformity. Entities should change accounting policies if those policies become inappropriate.

Corresponding information for preceding periods should be shown to enable comparison over time.

Verifiability

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

Timeliness

Information may become less useful if there is a delay in reporting it. There is a balance between timeliness and the provision of reliable information.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error.

Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

Understandability

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information on those phenomena might make the information easier to understand, but without it those reports would be incomplete and therefore misleading. Therefore matters should not be left out of financial statements simply due to their difficulty as even well-informed and diligent users may sometimes need the aid of an advisor to understand information about complex economic phenomena.

4.4.5 The cost constraint on useful financial reporting

This is a pervasive constraint, not a qualitative characteristic. When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a subjective area and there are other difficulties: others, not the intended users, may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but preparers and users should be aware of the constraint.
4.5 Chapter 4: The elements of financial statements

4.5.1 Overview

Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

The Conceptual Framework lays out these elements as follows.

<table>
<thead>
<tr>
<th>Elements of financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial position in the statement of financial position</td>
</tr>
<tr>
<td>• Assets</td>
</tr>
<tr>
<td>• Liabilities</td>
</tr>
<tr>
<td>• Equity</td>
</tr>
<tr>
<td>Performance in the statement of profit or loss and other comprehensive income</td>
</tr>
<tr>
<td>• Income</td>
</tr>
<tr>
<td>• Expenses</td>
</tr>
<tr>
<td>• Other comprehensive income</td>
</tr>
</tbody>
</table>

Contributions from equity participants and distributions to them are shown in the statement of changes in equity.

4.5.2 Definitions of elements

<table>
<thead>
<tr>
<th>Element</th>
<th>Definition</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.</td>
<td>Technically, the asset is the access to future economic benefits (eg cash generation) not the underlying item of property itself (eg a machine).</td>
</tr>
<tr>
<td>Liability</td>
<td>A present obligation of the entity arising from past events, the settlement of which is expected to lead to the outflow from the entity of resources embodying economic benefits.</td>
<td>An obligation implies that the entity is not free to avoid the outflow of resources.</td>
</tr>
<tr>
<td>Equity</td>
<td>The residual amount found by deducting all of the entity's liabilities from all of the entity's assets.</td>
<td>Equity = ownership interest = net assets. For a company, this usually comprises shareholders' funds (ie capital and reserves).</td>
</tr>
<tr>
<td>Income</td>
<td>Increases in economic benefits in the form of asset increases/liability decreases not resulting from contributions from equity participants.</td>
<td>Income comprises revenue and gains, including all recognised gains on non-revenue items (eg revaluations of non-current assets).</td>
</tr>
<tr>
<td>Expenses</td>
<td>Decreases in economic benefits in the form of asset decreases/liability increases not resulting from distributions to equity participants.</td>
<td>Expenses includes losses, including all recognised losses on non-revenue items (such as write-downs of non-current assets).</td>
</tr>
</tbody>
</table>

Note the way that the changes in economic benefits resulting from asset and liability increases and decreases are used to define:

- Income
- Expenses

This arises from the 'balance sheet approach' adopted by the Conceptual Framework which treats performance statements, such as the statement of profit or loss, as a means of reconciling changes in the financial position amounts shown in the statement of financial position.

These key definitions of 'asset' and 'liability' will be referred to again and again in these learning materials, because they form the foundation on which so many accounting standards are based. It is very important that you can reproduce these definitions accurately and quickly.
4.5.3 Assets

We can look in more detail at the components of the definitions given above.

Assets must give rise to future economic benefits, either alone or in conjunction with other items.

**Definition**

**Future economic benefit**: The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

In simple terms, an item is an asset if:

- It is cash or the right to cash in future, eg a receivable, or a right to services that may be used to generate cash, eg a prepayment.
- or
- It can be used to generate cash or meet liabilities, eg a tangible or intangible non-current asset.

The existence of an asset, particularly in terms of control, is not reliant on:

- Physical form (hence intangible assets such as patents and copyrights may meet the definition of an asset and appear in the statement of financial position – even though they have no physical substance).
- Legal ownership (hence some leased assets, even though not legally owned by the company, may be included as assets in the statement of financial position. (See Chapter 7.)

Transactions or events in the past give rise to assets. Those expected to occur in future do not in themselves give rise to assets.

4.5.4 Liabilities

Again we look more closely at some aspects of the definition.

An essential feature of a liability is that the entity has a present obligation.

**Definition**

**Obligation**: A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

As seen above, obligations may be:

- Legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case with amounts payable for goods and services received.
- The result of business practice. For example, even though a company has no legal obligation to do so, it may have a policy of rectifying faults in its products even after the warranty period has expired.

A management decision (to acquire an asset, for example) does not in itself create an obligation, because it can be reversed. But a management decision implemented in a way which creates expectations in the minds of customers, suppliers or employees, becomes an obligation. This is sometimes described as a constructive obligation. This issue is covered more fully in Chapter 9 in the context of the recognition of provisions.

Liabilities must arise from past transactions or events. For example, the sale of goods is the past transaction which allows the recognition of repair warranty provisions.
Settlement of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. In practice, most liabilities will be met in cash but this is not essential.

Interactive question 1: Asset or liability? [Difficulty level: Easy]

<table>
<thead>
<tr>
<th>Question</th>
<th>Fill in your answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Oak plc has purchased a patent for £40,000. The patent gives the company sole use of a particular manufacturing process which will save £6,000 a year for the next five years.</td>
<td></td>
</tr>
<tr>
<td>(b) Elm plc paid John Brown £20,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.</td>
<td></td>
</tr>
<tr>
<td>(c) Sycamore plc provides a warranty with every washing machine sold.</td>
<td></td>
</tr>
</tbody>
</table>

See Answer at the end of this chapter.

4.5.5 Equity

Equity is the residual of assets less liabilities, so the amount at which it is shown is dependent on the measurement of assets and liabilities. It has nothing to do with the market value of the entity's shares.

Equity may be sub-classified in the statement of financial position providing information which is relevant to the decision-making needs of the users. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity.

In practical terms, the important distinction between liabilities and equity is that creditors have the right to insist that the transfer of economic resources is made to them regardless of the entity's financial position, but owners do not. All decisions about payments to owners (such as dividends or share capital buy-back) are at the discretion of management.

4.5.6 Performance

Profit is used as a measure of performance, or as a basis for other measures (eg earnings per share (EPS)). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

Income and expenses can be presented in different ways in profit or loss and in other comprehensive income, to provide information relevant for economic decision-making. For example, a statement of profit or loss could distinguish between income and expenses which relate to continuing operations and those which do not.

Items of income and expense can be distinguished from each other or combined with each other.

Income

Both revenue and gains are included in the definition of income. Revenue arises in the course of ordinary activities of an entity. (We will look at revenue in more detail in Chapter 6.)

Definition

Gains: Increases in economic benefits. As such they are no different in nature from revenue.

Gains include those arising on the disposal of non-current assets. The definition of income also includes unrealised gains, eg on revaluation of non-current assets.

A revaluation gives rise to an increase or decrease in equity.

These increases and decreases appear in other comprehensive income.

(Gains on revaluation, which are recognised in a revaluation surplus are covered in Chapter 4.)
Expenses

As with income, the definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity.

**Definition**

**Losses**: Decreases in economic benefits. As such they are no different in nature from other expenses.

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealised losses**.

### 4.6 Chapter 4: Recognition of the elements of financial statements

#### 4.6.1 Meaning of recognised

An item is recognised when it is included in the statement of financial position, statement of profit or loss or statement of other comprehensive income.

**Definition**

**Recognition**: The process of incorporating in the statement of financial position, statement of profit or loss or statement of other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity, and
- The item has a cost or value that can be measured with reliability.

**Points to note**

1. Regard must be given to materiality (see Section 4.4.3 above).
2. An item which fails to meet these criteria at one time may meet it subsequently.
3. An item which fails to meet the criteria may merit disclosure in the notes to the financial statements. (This is dealt with in more detail by IAS 37 Provisions, Contingent Liabilities and Contingent Assets which is covered in Chapter 9.)

#### 4.6.2 Probability of future economic benefits

Probability here refers to the **degree of uncertainty** that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the **characteristics of the entity’s environment** and the **evidence available** when the financial statements are prepared.

The Conceptual Framework does not give a definition of ‘probable’. A working definition is 'more likely than not'.

#### 4.6.3 Reliability of measurement

The cost or value of an item in many cases must be **estimated**. The use of reasonable estimates is an essential part of the preparation of financial statements and **does not undermine their reliability**. Where no reasonable estimate can be made, the item should not be recognised (although its existence should be disclosed in the notes).

#### 4.6.4 Recognition of items

We can summarise the recognition criteria for assets, liabilities, income and expenses, based on the definition of recognition given above.
### 4.7 Chapter 4: Measurement of the elements of financial statements

For an item or transaction to be recognised in an entity's financial statements it needs to be measured as a monetary amount. IFRS uses several different measurement bases but the Conceptual Framework refers to just four.

The four measurement bases referred to in the Conceptual Framework are:

- **Historical cost.** Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

- **Current cost.** Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

- **Realisable (settlement) value.**
  - **Realisable value.** The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
  - **Settlement value.** The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

- **Present value.** A current estimate of the present discounted value of the future net cash flows in the normal course of business.

**Historical cost** is the most commonly adopted measurement basis, but this is usually combined with other bases, eg an historical cost basis may be modified by the revaluation of land and buildings.
4.8 Chapter 4: Concepts of capital and capital maintenance

The final section of the Conceptual Framework is devoted to a brief discussion of the different concepts of capital and capital maintenance, pointing out that:

- The choice between them should be made on the basis of the needs of users of financial statements.
- The IASB has no present intention of prescribing a particular model.

4.8.1 Financial capital and capital maintenance

Definition

Financial capital maintenance: Under a financial concept of capital maintenance, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity.

The financial concept of capital is adopted by most entities.

This concept measures capital as the equity in the statement of financial position. Profit is only earned in an accounting period if the equity at the end of the period is greater than it was at the start, having excluded the effects of distributions to or contributions from the owners during the period.

Monetary measure of capital

Financial capital is usually measured in monetary terms, eg the £ sterling or the euro. This is the concept applied in historical cost accounting. This measure can be quite stable over short periods of years, but is debased by even quite low rates of general inflation over longer periods, such as 20 years. So comparisons between capital now and capital 20 years ago are invalid, because the measurement instrument is not constant.

Constant purchasing power

A variant on the monetary measure of financial capital is the constant purchasing power measure. On this basis, the opening capital (ie equity) is uprated by the change in a broadly based price index, often a retail prices index, over the year. Also, the transactions during the year are uprated by the change in the same index. A profit is only earned if the capital at the end of the year exceeds these uprated values. (The value of the uprating is taken to equity, but is not regarded as a profit, merely a 'capital maintenance' adjustment.) So this capital maintenance adjustment can be thought of as an additional expense. Comparisons over a 20-year period will be more valid if the capital 20 years ago is uprated for general inflation over that 20-year period.

However, there is no reason why inflation measured by a retail prices index should be at all close to the inflation experienced by an individual company. The physical capital maintenance concept (see below) seeks to address this.

4.8.2 Physical capital and capital maintenance

Definition

Physical capital maintenance: Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

This concept looks behind monetary values, to the underlying physical productive capacity of the entity. It is based on the approach that an entity is nothing other than a means of producing saleable outputs, so a profit is earned only after that productive capacity has been maintained by a 'capital maintenance' adjustment. (Again, the capital maintenance adjustment is taken to equity and is treated as an additional expense in the statement of profit or loss.) Comparisons over 20 years should be more valid than under a monetary approach to capital maintenance.

The difficulties in this approach lie in making the capital maintenance adjustment. It is basically a current cost approach, normal practice being to use industry-specific indices of movements in non-current assets, rather than go to the expense of annual revaluations by professional valuers. The difficulties lie in finding indices appropriate to the productive capacity of a particular entity.
Worked example: Capital maintenance concepts

Meercat plc purchased 20,000 electrical components on 1 January 20X7 for £10 each. They were all sold on 31 December 20X7 for £250,000. On that date the replacement cost of an electrical component was £11.50. The general rate of inflation as measured by the general price index was 12% during the year.

Profit could be calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Financial capital maintenance (monetary terms)</th>
<th>Financial capital maintenance (constant purchasing power)</th>
<th>Physical capital maintenance</th>
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<tr>
<td>Revenue</td>
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<td>Profit</td>
<td>50,000</td>
<td>26,000</td>
<td>20,000</td>
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5 The regulatory framework

Section overview
- Financial reporting is the provision of financial information to those outside the entity.
- The organisation responsible for setting IFRSs comprises the International Financial Reporting Standards Foundation (IFRS Foundation), the Monitoring Board, the International Accounting Standards Board (IASB), the IFRS Advisory Council (Advisory Council) and the IFRS Interpretations Committee (Interpretations Committee).
- The process of setting IFRSs is an open dialogue involving co-operation between national and international standard setters.

5.1 The IFRS Foundation

IASCF was formed in March 2001 as a not-for-profit corporation and was the parent entity of the IASB. In 2010 it was renamed as the IFRS Foundation. The IFRS Foundation is an independent organisation and its trustees exercise oversight and raise necessary funding for the IASB to carry out its role as standard setter. It also oversees the work of the IFRS Interpretations Committee (formerly called the International Financial Reporting Interpretations Committee (IFRIC)) and the IFRS Advisory Council (formerly called the Standards Advisory Council (SAC)). These are organised as follows:
5.2 Membership

Membership of the IFRS Foundation has been designed so that it represents an international group of preparers and users, who become IFRS Foundation trustees. The selection process of the 22 trustees takes into account geographical factors and professional background. IFRS Foundation trustees appoint the IASB members.

5.3 The IASB

The IASB is responsible for setting accounting standards. It is made up of 15 full-time members and has no particular geographical dominance. Members have a variety of backgrounds and include:

- Auditors
- Preparers of financial statements
- Users of financial statements
- Academics

5.4 Objectives of the IASB

The Preface to IFRSs states that the objectives of the IASB are as follows:

- To develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the various capital markets of the world and other users of the information to make economic decisions;
- To promote the use and rigorous application of those standards;
- In fulfilling the above objectives to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings; and
- To promote and facilitate the adoption of IFRSs through the convergence of national accounting standards and IFRSs.

5.5 The purpose of accounting standards

The overall purpose of accounting standards is to identify proper accounting practices for the preparation of financial statements.
Accounting standards create a **common understanding** between users and preparers on how particular items, for example the valuation of property, are treated. Financial statements should therefore comply with all applicable accounting standards.

### 5.6 Application of IFRS

Within each individual country **local regulations govern**, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies or professional accountancy bodies in the country concerned.

Over the last 25 years however, the **influence of IFRS on national accounting requirements and practices has been growing**. For example:

- Since accounting periods commencing on or after 1 January 2005, all EU companies whose securities are traded on a regulated public market such as the London Stock Exchange, **must prepare their consolidated accounts in accordance with IFRS**. (Note that although group financial statements must follow IFRS the **individual** financial statements do not need to.)
- In the UK **unquoted companies are permitted** (but not required) to adopt IFRS.

### 5.7 Setting of IFRS

The overall agenda of the IASB is initially set by discussion with the IFRS Advisory Council. The process for developing an individual standard involves the following steps.

**Step 1**
During the early stages of a project, IASB may establish an **Advisory Committee or working group** to give advice on issues arising in the project. Consultation with the Advisory Committee and the Advisory Council occurs throughout the project.

**Step 2**
IASB may develop and publish a **Discussion Paper** for public comment.

**Step 3**
Following the receipt and review of comments, IASB would develop and publish an **Exposure Draft** for public comment.

**Step 4**
Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

The period of exposure for public comment is normally 120 days. However, in some circumstances, proposals may be issued with a comment period of not less than 30 days. Draft IFRS Interpretations are exposed for a 60-day comment period.

### 5.8 Scope and authority of IFRS

The **Preface to IFRSs** makes the following points:

- **IFRS apply to all general purpose financial statements** ie those directed towards the common information needs of a wide range of users.
- The IASB's objective is to **require like transactions and events to be accounted for and reported in a like way**. The IASB intends not to permit choices in accounting treatment. The IASB is reconsidering those transactions and events for which IFRSs permit a choice of accounting treatment with the objective of reducing the number of those choices.
- Standards include paragraphs in bold and plain type. **Bold type paragraphs** indicate the **main principles**, but both types have equal authority.
- Any limitation of the applicability of a specific IFRS is made clear in that standard.
5.9 UK regulatory framework

5.9.1 UK standard-setting process

From 1 August 1990 to 2 July 2012 all UK accounting standards were issued by the Accounting Standards Board (ASB). From 2 July 2012 responsibility for issuing accounting standards was assumed by the Board of the Financial Reporting Council (FRC).

UK accounting standards are known as Financial Reporting Standards (FRSs). They include the Financial Reporting Standard for Smaller Entities (FRSSE). Prior to the formation of the ASB, standards were issued known as Statements of Standard Accounting Practice (SSAPs). Most of these have been replaced by FRSs, but some are still in force today.

FRSs are first issued as exposure drafts for consultation that are known as Financial Reporting Exposure Drafts (FREDs). FREDs are then amended or not according to the results of the consultation and issued as FRSs.

5.9.2 Abbreviated accounts and micro-entities

In the UK small companies are allowed to file abbreviated accounts. The thresholds for a small company are:

- Turnover below £6.5 million
- Balance sheet total below £3.26 million
- Fewer than 50 employees

Companies meeting two of these requirements can file an abbreviated profit and loss account. They must still file a balance sheet and an audit report.

The advantage of this to small companies is that abbreviated accounts cost less to prepare and give away less information to competitors. A possible downside is that they may give insufficient information for potential lenders.

In November 2013 the UK Government approved regulations that introduced simpler reporting for micro-entities – a newly-defined sub-category of small company. The qualifying conditions are:

- Turnover below £632,000
- Balance sheet total below £316,000
- Fewer than 10 employees

Certain types of organisation, including charities, LLPs, investment companies and insurance companies, are excluded from being treated as micro-entities.

The micro-entity regulations set out a simplified profit and loss account and balance sheet which can be filed by qualifying entities.

5.9.3 UK financial reporting

UK companies must produce their financial statements in line with the requirements of:

- The Companies Act 2006
- Accounting standards, whether IFRS or the UK Financial Reporting Standards

Companies whose shares or debt are traded on a regulated securities exchange have been required to prepare their consolidated financial statements in accordance with IFRS from 2005. (This requirement does not apply to the separate financial statements of the parent company or the separate financial statements of any subsidiaries, although it is permissible to use IFRS for these as well.) From 2007 onwards this regulation also applies to companies whose share capital or debt is traded on the London Alternative Investment Market (AIM).

All other companies can choose whether to prepare both consolidated and separate financial statements in accordance with UK GAAP or IFRS. However, when a company chooses to change the basis of preparation to IFRS, it cannot subsequently change back to using UK GAAP.

To date few companies have made a voluntary transition to IFRS. They have preferred to remain with UK GAAP.
In 2012 and 2013 the FRC revised UK financial reporting standards. This revision replaced all extant standards with three new Financial Reporting Standards:

- **FRS 100** Application of Financial Reporting Requirements
- **FRS 101** Reduced Disclosure Framework
- **FRS 102** The Financial Reporting Standard Applicable in the UK and Republic of Ireland

FRS 100 sets out the financial reporting requirements for UK and Republic of Ireland entities. These are as follows:

(a) An entity eligible to apply the FRSSE may continue to do so.

(b) Other entities should apply FRS 102 or, in the case of the individual financial statements of a qualifying entity, FRS 101.

A qualifying entity for the purposes of FRS 101 is a member of a group whose consolidated financial statements are prepared under IFRS. FRS 101 allows group members in their individual financial statements to take advantage of exemption from a number of disclosures required by full IFRS.

The IFRSs to which disclosure exemptions apply are: IAS 1, IAS 7, IAS 8, IAS 24, IAS 36, IFRS 2, IFRS 3, IFRS 5, IFRS 7 and IFRS 13. These exemptions are explained more fully in the relevant chapters of this manual for those standards which are included in the FAR syllabus.

Chapter 16 of this manual is dedicated to FRS 102, highlighting the accounting treatment under UK GAAP. A comparison with IFRS is summarised at the end of Chapter 16 and forms part of the examinable FAR syllabus.

### 6 Convergence process

**Section overview**

- There has been a drive in recent years towards increased harmonisation of accounting standards.
- Groups whose shares or debt are traded on a supervised securities exchange in EU countries must now prepare their consolidated financial statements under IFRS.
- The IASB Convergence programme includes collaboration with the US Financial Accounting Standards Board (FASB) in order to create a set of global reporting standards.
- In the UK the ASB has worked closely with the IASB in order to converge UK accounting standards with IFRS. This has resulted in new standards FRS 100, FRS 101 and FRS 102.

### 6.1 National and international financial reporting

Companies are required to prepare their financial statements according to the accounting requirements of the country in which the company is registered. In the UK this now means compliance with:

- Companies Act 2006
- FRSs 100, 101 and 102

The issue of these new UK standards is the result of UK/IFRS convergence. However, convergence with US GAAP may be some way off.

Many multi-national groups have their shares traded on stock exchanges in different countries around the world and have often been required to prepare financial statements in line with the reporting standards in each country; they have then needed to make adjustments prior to consolidating them in their home country under that country’s reporting standards.

US-based entities are required to prepare their financial statements in accordance with the financial reporting standards issued by the US FASB. Non-US entities which prepared their financial statements under different standards, such as IFRS, and whose shares are traded on a US stock exchange used to be required to prepare reconciliations of the profit and equity amounts measured under these different standards and the equivalent amounts under US GAAP. These restatements often required a substantial amount of work.
For some decades there has been increased pressure for the adoption of a single set of global accounting standards. This drive towards worldwide harmonisation of financial reporting has two main causes:

- Increased globalisation of trade and of capital markets, with the result that:
  - Management wants all group entities to produce financial statements on the same basis.
  - Investors and lenders are now adopting an international approach to their activities and want to be spared the trouble of having to understand a number of different bases for the preparation of financial statements.
- It is also the case that the increasing pace of information technology development now provides companies with the communications to take advantage of such harmonisation.

The benefits from the convergence of global financial reporting include:

- Reducing the cost of capital as investors/lenders understand all financial statements better
- Encouraging investment growth
- Improving the quality of financial reporting
- Reducing the time and cost of preparing financial statements

There are some who would also argue that there are costs of global convergence, in particular:

- The cost of changing accounting practices and systems to suit IFRS
- A perceived dilution of national sovereignty
- A concern that the desire to converge with US requirements (see below) will lead to standards which are really only appropriate for the very largest, international companies, which regularly raise finance on the capital markets. Such standards are just too complex, and compliance with them too expensive, for companies operating only in their domestic markets and raising the finance they need from their local banks

It should also be pointed out that convergence has appeared to lose momentum in recent years. This is perhaps due to renewed confidence in US GAAP within the US itself. Also, many US investors tend to see IFRS as a predominantly European project. The euro crisis has not helped persuade investors that accounting rules are in safe hands under IFRS. Nevertheless, convergence remains an ongoing objective.

6.2 The European Union

For many years the European Union (EU) has had an overall objective of creating a properly functioning internal market. It has therefore set a specific objective in the financial arena of developing an integrated and efficiently operating capital market. The adoption of internationally accepted accounting standards with few measurement options, leading to a single set of global accounting standards, is a major contribution to the achievement of this objective.

In 2000, as part of this process, the International Organisation of Securities Commissions (IOSCO) adopted a core set of IFRS for use by multi-national entities. IOSCO represents the regulators of securities markets and keeps a watching brief over the major regulatory issues associated with international securities in general and with multi-national disclosure and accounting in particular.

In June 2002 the European Commission issued a Regulation requiring the adoption of IFRS for the preparation of consolidated financial statements for financial periods starting on or after 1 January 2005 for entities incorporated in a member state and whose securities, debt or equity, are traded on a regulated market in the EU. The consolidated financial statements of many of Europe’s top multinationals are now prepared in conformity with national requirements, EC directives and IFRS. Member states currently have the discretion to extend the implementation of IFRS to include non-listed companies.

To maintain some political control over standards and prevent them being solely under the control of unelected accountants, the European Commission set up an endorsement mechanism whereby the European Parliament and the Council of the EU must adopt new international accounting standards before companies are required to comply with them. In deciding whether to adopt a standard they take advice from two committees:
The Accounting Regulatory Committee (ARC) which is made up of representatives of member states and works at a political level.

The European Financial Reporting Advisory Group (EFRAG) which is made up of technical experts such as national standard setters, national regulators and preparers and users of financial statements. This group provides advice to the Commission on all issues relating to the application of IFRS in the EU. It is expected to identify early in the development of an IFRS whether the IASB proposals are going to cause significant problems within the EU.

In 2006 the European Commission established a Standards Advice Review Group (SARG) whose task is to assess whether the endorsement advice given by EFRAG is well-balanced and objective.

Although the IASB issues IFRS, it has no legal authority to require compliance with them, so the use of IFRS requires specific legislation in each country or on the part of the EU. Within the EU enforcement is delegated to the regulatory authorities in member states, but must be carried out in line with the enforcement principles set out by the European Securities and Markets Authority (ESMA). These principles can be summarised as follows:

- The purpose of enforcement is to protect investors and promote securities market confidence.
- Enforcement shall take the form of a review to see whether IFRS have been properly complied with.
- Enforcement shall be ‘ex-post’, in that there shall be reviews of financial statements only after they have been published.
- The selection of financial statements to be reviewed should combine a risk-based approach together with a sampling and/or rotation approach.
- Total reliance on a risk-based approach may be acceptable, but total reliance on a rotation approach is not.
- A purely reactive approach (conducting a review only when someone complains) is not acceptable.
- Restatements of financial statements should be demanded where appropriate.

In 2010 regulatory authorities within the EU performed full reviews of 1,000 (2009: 1,200) companies’ accounts covering 15% of listed entities and partial reviews of 700 (2009: 900) accounts covering 10% of listed entities. In 22 cases (2009: 19) revised financial statements had to be issued and in 220 cases (2009: 160) corrective notes had to be issued. Impairment of assets, financial and other, was the most problematic area.

In early 2014 the European Parliament issued a draft Directive on Statutory Audit. The proposed legislation requires EU auditors to publish audit reports according to ISAs and introduces a new ‘mandatory rotation’ rule. Public-interest entities will be obliged to put their audit out to tender every 10 years. EU auditors will no longer be allowed to provide certain non-audit services to their clients and the rules establish a cap on fees generated for non-audit services to public-interest entities.

In the UK there are three main bodies which regulate financial statements:

- The Financial Conduct Authority (FCA) which is the UK regulator of financial services. The FCA supervises the provision of information to the investing public when an entity wishes to make a public offering of its securities.
- The Prudential Regulation Authority which regulates banks, building societies and insurance companies.
- The Financial Reporting Review Panel (FRRP)

The FRRP is independent of the ASB but is, like it, answerable to the Financial Reporting Council. It was set up to enquire into financial statements and directors’ reports which appear not to comply with the requirements laid down in the UK. In line with the ESMA principles it adopts a proactive approach to the review of all financial information within its remit. If the FRRP considers that inappropriate accounting has been adopted, its aim is to reach agreement with the directors for the voluntary restatement of financial statements. Failing voluntary correction, the FRRP does have the power to restate the financial statements through a court order.

Unlisted companies in the UK now report under FRS 102 The Financial Reporting Standard Applicable in the UK and Republic of Ireland, which is based on the IFRS for SMEs (see Chapter 16). FRS 102 is effective
from January 2015 and applies to entities not applying EU-adopted IFRS, FRS 101 Reduced Disclosure Framework, or the FRSSE (see further in section 6.6 below).

6.3 IASB and US regulators

IFRS are leading the way as the generally accepted accounting standards for capital market reporting outside of the US. However, an overwhelming volume of financial capital is traded through US markets, and any attempts at global convergence must incorporate the US at its core.

After a joint meeting in September 2002, the US FASB and the IASB issued their Norwalk Agreement. In this agreement they each:

- Acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting,
- Pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable, and
- Pledged to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained.

This is known as the IASB Convergence Project and IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations was the first standard to be issued as a result of this agreement.

6.4 Progress in general convergence

In October 2004 and subsequent to the Norwalk Agreement there was an agreement between IASB and FASB to develop a common conceptual framework. The intention was to divide the project into two phases:

- The initial focus being on particular aspects of the framework such as objectives, qualitative characteristics, elements, recognition and measurement,
- In the later stage to apply these aspects to other aspects (see below).

In February 2006 ‘A Roadmap for convergence between IFRSs and US GAAP 2006–2008 Memorandum of Understanding between the FASB and IASB’ (known as the Memorandum of Understanding (MoU)) was issued. Progress on convergence was such that in November 2007 the Securities and Exchange Commission (SEC), the regulator of US securities markets removed the requirement referred to above for non-US companies listed in the US and reporting under IFRS to prepare the reconciliations of profit and equity under IFRS to the amounts under US GAAP.

In November 2008 the SEC produced for comment its proposals for a ‘Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by US Issuers’. The proposals were revised in 2010 and now set out six headings on which progress needs to be made. These headings include:

- Further improvements to IFRS
- Changes to the accountability and funding arrangements for the IFRS Foundation, to demonstrate beyond doubt its independence
- Investor understanding and education regarding IFRS

If these proposals are adopted and assuming that the SEC judges that sufficient progress has been made under the six headings, then the use of IFRS, as opposed to US financial reporting standards, would become compulsory for all US entities, starting in approximately 2015 or 2016. This would be a major step along the road to a single set of global reporting standards.

As well as the work on convergence between IFRS and US standards, the IASB has also been working closely on projects with the national accounting standard setters of Canada, Japan and China, all of which countries are committed to adopting or converging their national financial reporting standards with IFRS.
6.5 Conceptual framework

An essential part of harmonising US GAAP and IFRS was to create a common conceptual framework. An agreement on the underpinning concepts is seen as vital to international convergence.

The IASB and the US FASB have done some work towards developing a common conceptual framework (that is a single converged framework) which is:

- Complete and internally consistent.
- An improvement on the existing frameworks of both boards.
- Capable of providing a sound foundation for developing future accounting standards.
- Essential to fulfilling the boards’ goal of developing standards that:
  - Are principles-based
  - Are internally consistent
  - Are internationally converged, and
  - Lead to financial reporting that provides the information needed for investment, credit and similar decisions.

The boards were conducting the project in eight phases.

<table>
<thead>
<tr>
<th>Phase</th>
<th>Topic</th>
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<tbody>
<tr>
<td>A</td>
<td>Objectives and qualitative characteristics</td>
</tr>
<tr>
<td>B</td>
<td>Definitions of elements, recognition and derecognition</td>
</tr>
<tr>
<td>C</td>
<td>Measurement</td>
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<tr>
<td>D</td>
<td>Reporting entity concept</td>
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<tr>
<td>E</td>
<td>Boundaries of financial reporting and presentation and disclosure</td>
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<td>G</td>
<td>Application to not-for-profit entities</td>
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<tr>
<td>H</td>
<td>Remaining issues, if any</td>
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</tbody>
</table>

Phase A was completed and implemented (see Section 4 above) and an exposure draft in respect of Phase D was published in March 2010. Work had started in relation to Phases B and C also. However, during late 2010, the IASB effectively deferred further work on the joint project until after more urgent convergence projects were finalised. The project was then reactivated in September 2012 as an IASB only project. In July 2013 the IASB issued a Discussion Paper as a first step towards issuing a revised Conceptual Framework.

6.6 Convergence of UK standards and IFRS

The convergence process between UK GAAP and IFRS began in 2003 but was subsequently paused. During that time, UK standards did not keep pace with business changes and with evolving types of transaction, particularly with regard to financial instruments. The FRC undertook a consultation process over a number of years. During this process Deloitte remarked that most trainees were now being trained on IFRS, making UK GAAP ‘a dying language’ and ICAEW commented that ‘UK GAAP is now outdated and in places lacks coherence, and action to rectify the situation is long overdue’.

The FRC took the view that the optimum solution was a transition to an IFRS-based framework and over the course of 2012 and 2013 issued three new standards.

- **FRS 100 Application of Financial Reporting Requirements** – issued November 2012  
- **FRS 101 Reduced Disclosure Framework** – issued November 2012  
- **FRS 102 The Financial Reporting Standard Applicable in the UK and Republic of Ireland** – issued March 2013
FRS 100 provides rules and guidance on how to select the appropriate accounting framework for a particular entity or group.

FRS 101 provides a reduced disclosure framework for qualifying entities, such as subsidiaries of groups reporting under IFRS.

FRS 102 replaces the majority of UK accounting standards, adopts an IFRS-based framework and improves accounting for financial instruments. It is based on the IFRS for SMEs, amended to ensure compliance with company law. It is intended for all UK entities other than those applying the FRSSE, or listed companies preparing group financial statements, who are already required to report under IFRS. Such companies will still be allowed to apply FRS 101 or FRS 102 in preparing their individual entity financial statements.

UK companies currently reporting under IFRS will be allowed to move to FRS 102 if they are reporting under IFRS on a voluntary basis. If they are required to report under IFRS (consolidated financial statements of a listed company) they will continue to do so.

The objectives and intended effects of the new standards are stated by the FRC to be ‘to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users’ information needs’.

FRS 102 has 35 chapters based mainly on the IFRS for SMEs with some cross-reference to full IFRS. The disclosure requirements are less than for full IFRS. Some of the changes that will impact UK companies on moving to FRS 102 are:

- New requirements for financial instruments, bringing all derivatives on balance sheet at fair value
- More intangible assets to be recognised separately from goodwill when there is a business combination
- Useful life of goodwill and intangible assets not to exceed five years when no reliable estimate can be made
- Merger accounting only permitted in limited cases

The new standards are mandatory for accounting periods beginning on or after 1 January 2015.

UK companies should benefit in a number of ways from the transition to FRS 102:

- For private companies that are looking for venture capital, private equity or to make the transition to a public market, moving to IFRS-based reporting will be an advantage to potential investors in terms of making it easier to compare financial performance
- Improved transparency against international companies
- Assistance to overseas trade development with international partners

7 Inherent limitations of financial statements

Section overview

There are limitations inherent in financial statements, including the fact that they are:

- A conventionalised representation, involving classification, aggregation and the allocation of items to particular accounting periods
- Historical (backward-looking), and
- Based almost exclusively on financial data

Integrated reporting attempts to deal with some of these limitations.
7.1 Conventionalised representation

Financial statements are **highly standardised** in terms of their overall format and presentation although businesses are very diverse in their nature. This may limit the usefulness of the information.

Financial statements are **highly aggregated** in that information on a great many transactions and balances is combined into a few figures in the accounts, which can often make it difficult for the reader to evaluate the components of the business.

Allocation issues include, for example, the application of the accrual concept and depreciation of non-current assets, where management’s judgements and estimates affect the period in which expenses or income are recognised.

7.2 Backward-looking

Financial statements are **backward-looking** whereas most users of financial information base their decisions on expectations about the future. Financial statements contribute towards this by helping to identify trends and by confirming the accuracy of previous expectations, but cannot realistically provide the complete information set required for all economic decisions by all users.

7.3 Omission of non-financial information

By their nature, financial statements contain financial information. They do not generally include non-financial data such as:

- **Narrative description** of the major operations
- **Discussion of business risks and opportunities**
- **Narrative analysis** of the entity’s performance and prospects
- **Management policies** and how the business is governed and controlled

Financial statements include the elements as defined in the IASB *Conceptual Framework*. This means that items which do not meet those definitions are not included. For example, the value of the entity’s internally generated goodwill ie through its reputation, loyalty and expertise of its management and employees, or its client portfolio. While some companies do experiment with different types of disclosure for such items, these disclosures are considered unsuitable for inclusion in the financial statements (precisely because such items do not fall within its definition of assets).

7.4 Other sources of information

Some of the limitations of financial statements are addressed in the **other information** which is often provided along with the financial statements, especially by large companies, such as operating and financial reviews and the Chairman’s statement.

There are also many other sources of information available to at least some users of financial statements, for example:

- In owner-managed businesses, the owners have access to internal management information because they are the management. This information is, potentially, available on a continuous real-time basis and may include:
  - Future plans for the business
  - Budgets or forecasts
  - Management accounts, including, for example, divisional analysis
- Banks will often obtain additional access to entity information under the terms of loan agreements
- Potential investors (eg if they are planning to take a major stake or even a controlling interest) will often negotiate additional access to corporate information
- Publicly available information, such as entity brochures and publicity material (eg press releases)
- Brokers’ reports on major companies
- Press reports and other media coverage (eg television or internet)
7.5 Integrated reporting

Integrated reporting (IR) presents an organisation’s strategy, governance and performance in terms of its wider social, environmental and economic context. By reinforcing these connections it is thought that IR can help an organisation to take more sustainable decisions and enable stakeholders to understand how the organisation is really performing.

The International Integrated Reporting Council (IIRC) was set up in 2010 comprising a cross-section of leaders from corporate investment, accounting, regulatory and standard-setting bodies and the Integrated Reporting Framework was released in December 2013.

The Framework reflects the IIRC’s view that corporate reporting must evolve to communicate the full range of factors that affect an organisation’s ability to create value over time.

The FRC has now issued guidance stating that annual reports should include information about a company’s human rights approach, gender representation and greenhouse gas emissions. This will form part of a new strategic report which will include strategy, business model and principal risks and challenges.

8 Not-for-profit entities

Section overview

- Not-for-profit entities include charities, clubs, and public sector organisations.
- Reporting requirements will vary depending on the nature of the entity.

8.1 Not-for-profit entities

The objective of most company directors is to manage the shareholders’ investment. In a majority of cases this will mean creating a profit. However, this is not always the case. For some entities their primary purpose is to provide a service rather than to make a profit.

Interactive question 2: Not-for-profit entities

List as many types of not-for-profit organisations as you can.

See Answer at the end of this chapter.

As this exercise has demonstrated not-for-profit entities include a broad range of organisations involved in very different activities. Not-for-profit entities also vary considerably in size from the local rugby club to an internationally renowned charity.

8.2 Reporting requirements

Many of the organisations mentioned above may be companies. In this case they will need to prepare financial statements and have them audited in accordance with local legislation and accounting regulation. In the UK this would include compliance with the Companies Act and UK accounting standards.

For unincorporated entities the reporting requirements are normally less onerous, although best practice would be to follow local GAAP (see Section 1.5).

In addition, many not-for-profit organisations will need to comply with regulations specific to their sector. For example in the UK, charities are required to comply with the Charities Act 1993, as updated by the Charities Act 2006, and the Statement of Recommended Practice: Accounting and Reporting by Charities.
8.3 International public sector accounting standards

International Public Sector Accounting Standards (IPSAS) are issued by the International Public Sector Accounting Standards Board (IPSASB). The objective of IPSASB is to:

- Develop **high quality** public sector financial reporting standards.
- Facilitate **convergence** of international and national standards.
- Enhance the **quality and uniformity** of financial reporting.

Currently there is **no general requirement** for IPSAS to be adopted and in jurisdictions where national standards already exist it is the local regulation which will be applied. The IPSASB however, envisage an increasing role for IPSAS in future, particularly in the following areas:

- Assisting **national standard-setters** in the development of new standards and the revision of existing standards.
- Being applied in jurisdictions **where there is no national legislation**.

9 Ethical and professional issues

**Section overview**

- The ICAEW has issued a Code of Ethics which is principles-based and centres around five fundamental principles.
- A professional accountant is responsible for recognising and assessing the potential threats to these fundamental principles.
- A professional accountant must then implement safeguards to eliminate these threats or reduce them to an acceptable level.

9.1 ICAEW Code of Ethics

Chartered Accountants are expected to demonstrate the highest standards of professional conduct and to take into consideration the public interest. Ethical behaviour by Chartered Accountants plays a vital role in ensuring public trust in financial reporting and business practices and upholding the reputation of the accountancy profession.

The ICAEW’s Code of Ethics (the Code) applies to all its members and is based upon the International Federation of Accountants (IFAC) Code of Ethics.

The Code is **principles-based** and members are responsible for:

- Identifying threats to compliance with the fundamental principles.
- Evaluating the significance of these threats.
- Implementing safeguards to eliminate them or reduce them to an acceptable level.

The guidance in the Code is given in the form of:

- Fundamental principles
- Illustrations as to how they are to be applied in specific situations

The Code applies to all members, students, affiliates, employees of member firms and, where applicable, member firms, in all of their professional and business activities, whether remunerated or voluntary. The ICAEW is committed to enforcing the Code through disciplining members who do not meet reasonable ethical and professional expectations of the public and other members.

A copy of the Code is included in the Member’s Handbook and is available at www.icaew.com.

Members (or students) who are in doubt as to their ethical position may seek advice from the following ICAEW sources:

- The ethics advisory helpline within Technical Advisory Services. The advisor is exempt from the normal duty to report misconduct, hence details of the ethical problem will not be divulged to third parties, including other departments of the ICAEW.
• The Support Members Scheme. This is wider in scope than the Technical Advisory Services. The Scheme is run by volunteer members of the ICAEW from a wide range of backgrounds. It is a confidential, free service exempt from the duty to report misconduct and provides advice and help to members in difficulties.

• Money laundering helpline. This helpline offers advice on all aspects of complying with the money laundering legislation. The advisors can answer calls on both general issues concerning the regulations and reporting suspected illegal activity, and specific issues, which can be discussed anonymously.

9.2 Fundamental principles

Professional accountants are expected to follow the guidance contained in the fundamental principles in all of their professional and business activities. The professional accountant should also follow the requirements in the illustrations. However, he/she should be guided not just by the terms but also by the spirit of the Code.

The Code sets out five fundamental principles, the spirit of which must always be complied with:

1 Integrity

A professional accountant should be straightforward and honest in all professional and business relationships.

A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information:

• Contains a materially false or misleading statement.

• Contains statements or information furnished recklessly.

• Omits or obscures information required to be included where such omission or obscurity would be misleading.

2 Objectivity

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

3 Professional competence and due care

A professional accountant has an obligation to:

• Maintain professional knowledge and skill at the level required to ensure that a client/employer receives competent professional services based upon current developments in practice, legislation and techniques.

• Act diligently and in accordance with applicable technical and professional standards.

Professional competence may be divided into two separate phases:

• Attainment of professional competence – initial professional development

• Maintenance of professional competence – continuing professional development (CPD)

Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

4 Confidentiality

A professional accountant should:

• Respect the confidentiality of information acquired as a result of professional and business relationships.

• Not disclose any such information to third parties without proper and specific authority (unless there is a legal or professional duty to disclose).

• Not use such information for the personal advantage of himself or third parties.

The professional accountant must maintain confidentiality even in a social environment and even after employment with the client/employer has ended.
A professional accountant may be required to disclose confidential information:

- Where disclosure is permitted by law and is authorised by the client or employer.
- Where disclosure is required by law, for example
  - Production of documents or other provision of evidence in the course of legal proceedings
  - Disclosure to the appropriate public authorities of infringements of the law that come to light

5 Professional behaviour

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

In marketing and promoting themselves professional accountants should not bring the profession into disrepute. That is, they should not make:

- Exaggerated claims for the services they are able to offer, the qualifications they possess or experience they have gained.
- Disparaging references or unsubstantiated comparisons to the work of others.

Two sets of legislation which may have a particular impact on the work of a professional accountant are:

- Money laundering regulations
  Money laundering is the process by which money from illegal sources is made to appear legally derived and it is a criminal offence for a person knowingly to help another person launder the proceeds of criminal activity.
  In addition, there is a duty to report. Where a person discovers in the course of his/her work information which makes him/her believe or suspect, or where a person has reasonable grounds for being suspicious, that money laundering is occurring, this must be reported to the National Crime Agency. It is a criminal offence not to make such a report. Making such a report does not breach any duty of confidentiality owed by a professional accountant.

- Bribery Act 2010
  For individuals it is a criminal offence to:
  - Offer, promise or give a financial or other advantage to another person where the advantage is intended to induce improper performance of an activity or a function or as a reward for the improper performance of an activity or a function.
  - Request, agree to receive or accept a financial or other advantage intending that, in consequence (or as reward for), a relevant function or activity be performed improperly (even if performance is by another person).
  - Offer, promise or give a financial or other advantage to a foreign public official in order to obtain or retain business or retain or gain an advantage in the conduct of business.
  The definition of function or activity is wide and includes any activity connected with a business.
  A commercial organisation is guilty of a criminal offence if an employee, agent or subsidiary of the organisation bribes another person to obtain/retain business.
  It should be noted that the Act includes offences committed outside of the UK by UK citizens.

9.3 Threats

Compliance with these fundamental principles may potentially be threatened by a broad range of circumstances. Many of these threats fall into five categories:

A **Self-interest threat** the threat that a financial or other interest of a professional accountant or of an immediate or close family member will appropriately influence the professional accountant’s judgment or behaviour.

Examples of circumstances that may create such threats include:

- Financial interests, loans or guarantees
- Incentive compensation arrangements
• Inappropriate personal use of corporate assets
• Concern over employment security
• Commercial pressure from outside the employing organisation

B **Self-review threat** the threat that a professional accountant will not appropriately evaluate the results of a previous judgement made by the professional accountant.

C **Advocacy threat** the threat that a professional accountant will promote a client’s or employer’s position to the point that the professional accountant’s objectivity is compromised.

D **Familiarity threat** the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work.

Examples of circumstances that may create such threats include:
• A professional accountant in business, who is in a position to influence financial or non-financial reporting or business decisions, where an immediate or close family member would benefit from that influence.
• Long association with business contacts influencing business decisions.
• Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

E **Intimidation threat** the threat that a professional accountant will be deterred from acting objectively by threats, either actual or perceived.

Examples of circumstances that may create such threats include:
• Threat of dismissal or replacement in business, of yourself, or of a close or immediate family member, over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.
• A dominant personality attempting to influence the decision making process, for example, with regard to the awarding of contracts or the application of an accounting principle.

### 9.4 Safeguards

There are two broad categories of safeguards which may eliminate or reduce such threats to an acceptable level:

**Safeguards created by the profession, legislation or regulation**

Examples are:
• Educational, training and experience requirements for entry into the profession
• Continuing professional development requirements
• Corporate governance regulations
• Professional standards
• Professional or regulatory monitoring and disciplinary procedures
• External review by a legally empowered third party of reports, returns, communication or information produced by a professional accountant
• Effective, well-publicised complaints systems operated by the employing organisation, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behaviour
• An explicitly stated duty to report breaches of ethical requirements

**Safeguards in the work environment**

Examples are:
• The employing organisation’s systems of corporate oversight or other oversight structures
• The employing organisation’s ethics and conduct programmes
• Recruitment procedures in the employing organisation emphasising the importance of employing high calibre, competent staff
• Strong internal controls
• Appropriate disciplinary processes
• Leadership that stresses the importance of ethical behaviour and the expectation that employees will act in an ethical manner
• Policies and procedures to implement and monitor the quality of employee performance
• Timely communication to all employees of the employing organisation’s policies and procedures, including any changes made to them, and appropriate training and education given on such policies and procedures
• Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organisation any ethical issues that concern them without fear of retribution
• Consultation with another appropriate professional accountant

9.5 Ethical conflict resolution

When evaluating compliance with the fundamental principles, a professional accountant may be required to resolve a conflict in complying with the fundamental principles.

A professional accountant may face pressure to:
• Act contrary to law or regulation.
• Act contrary to technical or professional standards.
• Facilitate unethical or illegal earnings management strategies.
• Lie to, or otherwise mislead, others in particular:
  – The auditor of the employing organisation
  – Regulators
• Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, for example:
  – Financial statements
  – Tax compliance
  – Legal compliance
  – Reports required by securities regulators

When dealing with such a conflict resolution the following should be considered:
• Relevant facts
• Relevant parties
• Ethical issues involved
• Fundamental principles related to the matter in question
• Established internal procedures
• Alternative courses of action

In this case he/she should:
• Determine the appropriate course of action that is consistent with the fundamental principles.
• Weigh up the possible consequences of each course of action.
• Consult with other appropriate persons if the matter remains unresolved.
• Obtain professional advice from the Institute or legal advisers, if it cannot be resolved.
• Finally if it remains unresolved refuse to remain associated with the matter creating the conflict.
9.6 Preparation and reporting of information

Accountants will often be involved in the preparation and reporting of information that may be:

- Made public or
- Used by others inside or outside the employing organisation.

The accountant should:

- Prepare or present such information fairly, honestly and in accordance with relevant professional standards.
- Present financial statements in accordance with applicable financial reporting standards.
- Maintain information for which (s)he is responsible in a manner which:
  - Describes clearly the true nature of the business transactions, assets or liabilities
  - Classifies and records information in a timely and proper manner
  - Represents the facts accurately and completely in all material respects

9.7 Acting with sufficient expertise

An accountant should only undertake significant tasks for which (s)he has, or can obtain, sufficient specific training or expertise.

Circumstances that threaten the ability of the accountant to perform duties with the appropriate degree of professional competence and due care include:

- Insufficient time for properly performing or completing the relevant duties
- Incomplete, restricted or otherwise inadequate information for performing the duties properly
- Insufficient experience, training and/or education
- Inadequate resources for the proper performance of the duties

Safeguards that may be considered include:

- Obtaining additional advice or training.
- Ensuring that there is adequate time available for performing the relevant duties.
- Obtaining assistance from someone with the necessary expertise.
- Consulting where appropriate with:
  - Superiors within the employing organisation, or
  - Independent experts, or
  - ICAEW

9.8 Financial interests

An accountant may have financial interests, or may know of financial interests of immediate or close family members, that could in certain circumstances, threaten compliance with the fundamental principles.

Examples of circumstances that may create self-interest threats, are if the accountant or family member:

- Holds a direct or indirect financial interest in the employing organisation and the value of that interest could be directly affected by decisions made by the accountant.
- Is eligible for a profit related bonus and the value of that bonus could be directly affected by a decision made by the accountant.
- Holds, directly or indirectly, share options in the employing organisation, the value of which could be directly affected by decisions made by the accountant.
- Holds, directly or indirectly, share options in the employing organisation which are, or will soon be, eligible for conversion.
- May qualify for share options in the employing organisation or performance-related bonuses if certain targets are achieved.
Safeguards against such threats may include:

- Policies and procedures for a committee independent of management to determine the level or form of remuneration of senior management.
- Disclosure of all relevant interests and of any plans to trade in relevant shares to those charged with the governance of the employing organisation, in accordance with any internal policies.
- Consultation, where appropriate, with superiors within the employing organisation.
- Consultation, where appropriate, with those charged with the governance of the employing organisation or relevant professional bodies.
- Internal and external audit procedures.
- Up-to-date education on ethical issues and the legal restrictions and other regulations around potential insider trading.

### 9.9 Inducements

An accountant, or immediate or close family, may be offered an inducement such as:

- Gifts
- Hospitality
- Preferential treatment
- Inappropriate appeals to friendship or loyalty

An accountant should assess the risk associated with all such offers and consider whether the following actions should be taken:

- Immediately inform higher levels of management or those charged with governance of the employing organisation.
- Inform third parties of the offer for example a professional body or the employer of the individual who made the offer, or seek legal advice.
- Advise immediate or close family members of relevant threats and safeguards where they are potentially in positions that might result in offers of inducements (for example as a result of their employment situation).
- Inform higher levels of management or those charged with governance of the employing organisation where immediate or close family members are employed by competitors or potential suppliers of that organisation.

### 9.10 Conflicts of interest

An accountant should take reasonable steps to identify circumstances that could pose a conflict of interest.

Examples might be:

- An accountant in public practice, competing directly with a client, or having a joint venture or similar arrangement with a major competitor of a client.
- An accountant performing services for clients whose interests are in conflict.
- Clients are in dispute with each other in relation to the matter or transaction in question.

Safeguards should include:

- Notifying the client of the firm’s business interest or activities that may represent a conflict of interest, and obtaining their consent to act in such circumstances.
- Notifying all known relevant parties that the professional accountant is acting for two or more parties in respect of a matter where their respective interests are in conflict and obtaining their consent to so act.
- Notifying the client that the accountant does not act exclusively for any one client in the provision of proposed services and obtaining their consent to so act.
9.11 General duty to report

Under the ICAEW’s Bye-laws it is the duty of every member where it is in the public interest to do so, to report to the Institute any facts or matters indicating that a member and/or firm or provisional member may have become liable to disciplinary action. In determining whether it is in the public interest to report such facts or matters, regard shall be had to such guidance as the Council shall give from time to time.

This general duty to report to the Institute under the Bye-laws is separate from the duty to report money laundering (see above) to the National Crime Agency; this latter duty arises from legislation.

Worked example: Ethical considerations

You are a reporting accountant in a company. Your immediate manager is a very forceful, domineering individual and you have accepted his views over the last two years on the level of work in progress. He has given you specific assurance that work in progress has increased by 200% during the current reporting period and instructed you to report this level in the monthly management accounts. The year end draft financial accounts show that the organisation has only just met its business plan financial targets.

Evidence then becomes available (which you were not aware of when the draft accounts were produced) to indicate that the work in progress had not increased by anywhere near the rate advised by your manager.

How should you approach this?

Solution

Key fundamental principles

Integrity – Will you be able to demonstrate that the accounts are true and fair without re-drafting?

Objectivity – How would you maintain your objectivity given that your immediate manager is such a forceful character?

Professional competence and due care – Are the draft accounts prepared in accordance with technical and professional standards?

Professional behaviour – How should you proceed so as not to discredit yourself?

Discussion

Identify relevant facts: Consider the business’ policies, procedures and guidelines, accounting standards, best practice, Code of Ethics, applicable laws and regulations. Is the evidence that work in progress is incorrectly stated supported by other documentation, for example, any hard copy relating to the valuation, or analytical review of cost of sales, margins and cash flows?

Identify affected parties: Key affected parties are you and your immediate manager. Other possible affected parties are the next levels of management, recipients of management accounts and the draft financial accounts, finance, purchasing, accounts payable, human resources, internal audit, audit committee, the Board, external auditors, shareholders and financial backers.

Who would be involved in resolution? Consider not just who should be involved but also for what reason and the timing of their involvement. Have you thought of contacting the ICAEW for advice and guidance? Have you discussed this matter with your immediate line manager in light of all the available evidence and possible consequences? Can you discuss this matter with recipients of the management and financial accounts? At what point will you consider involving other affected parties?

Possible course of action

Check the relevant facts by corroborating with other available documentation, for example, cost of sales calculations, margins, previous inventory counts and other financial information.

Discuss the matter with your immediate line manager to determine an appropriate course of action, for example, undertaking another inventory count.
If you feel that your manager’s response is not appropriate, discuss the matter with recipients of the management accounts and draft financial accounts and the next level of management.

Next stages could include discussion with senior management, internal audit, audit committee, the board of directors, external auditors or other actions indicated in internal whistle-blowing procedures.

During the resolution process it may be helpful to document your involvement, the substance of the discussions held, who else was involved, what decisions were made and why.

**Interactive question 3: Ethical considerations**  
[Difficulty level: Intermediate]

Your employer has put you in charge of a project which when you considered it carefully requires expertise that you do not have. You are uneasy about doing the job given that you do not have the necessary expertise and are uncertain about what to say to your employer.

Fill in the proforma below.

**Key fundamental principles**

**Discussion**

**Possible course of action**

See Answer at the end of this chapter.

9.12 **Practical significance**

Accountants working within a financial reporting environment can come under pressure to improve the financial performance or financial position of their employer. Finance managers who are part of the team putting together the results for publication must be careful to withstand pressures from their non-finance colleagues to indulge in reporting practices which dress up short-term performance and position. Financial managers must be conscious of their professional obligations and seek appropriate assistance from colleagues, peers or independent sources.
Self-test

Answer the following questions.

1. What are the conditions which the Conceptual Framework identifies as necessary if the going concern basis is to be used for the preparation of financial statements?

2. According to the Conceptual Framework what are the characteristics of information which is faithfully represented?

3. Discuss whether the move towards global accounting standards has been successful.

4. TRADITIONAL FRUITS LTD

Traditional Fruits Ltd, a Herefordshire based fruit bottling and canning company, is looking to expand its operations. The directors are hoping to increase the range of preserved fruit products and in doing so will need to invest in new equipment. They are also hoping to open a new facility in the South East near to the fruit farms of Kent and Surrey.

The finance director has been asked to prepare a résumé of the financial performance of the company in order that possible providers of finance can assess the future potential of the company.

The finance director wants to address all issues in her résumé and has asked for your assistance.

Requirements

Prepare brief notes for the finance director, addressing each of the following and using the Conceptual Framework as a source of reference.

(a) Identify potential providers of finance for Traditional Fruits Ltd and their information requirements in respect of financial statements.

(b) Explain the terms 'performance' and 'position' and identify which of the financial statements will assist the user in evaluating performance and position.

(c) Indicate why, for decision-making purposes, the financial statements alone are insufficient.

5. DAVIES AND SAYERS LTD

Davies and Sayers Ltd (D&S Ltd) is a well-known publisher of children’s educational books. The finance director, Carol Roberts, is known for her commercial acumen rather than her technical ability. She is therefore seeking your advice on two particular accounting issues.

(1) Value of head of publishing

D&S Ltd have recently appointed a new head of publishing, Jane Lindsay. Jane recently worked for a key competitor, Surridge and Hughes plc (S&H plc). Jane is extremely popular amongst the leading authors in the market and is sure to attract the services of certain authors currently working for S&H plc. Carol believes that Jane is therefore of great value to D&S Ltd and that such value should therefore be recognised in the statement of financial position in the form of an asset.

(2) Provision for alleged breach of copyright

Carol is aware that Poppy Anderson, one of D&S Ltd’s authors, is being accused of ‘including ideas in her texts that have previously been published’. Carol is certain a legal case will ensue and therefore, being prudent, wishes to recognise a liability in the accounts now for any damages that are likely to arise.

Requirements

Using the Conceptual Framework

(a) Define the terms ‘asset’, ‘liability’ and ‘recognised’.

(b) Prepare brief notes for Carol Roberts, discussing whether the above result in an asset or liability and whether or not they should be recognised in the financial statements.

Note: You are not required to refer to specific IFRSs that may be relevant.
You are the financial controller of Tattanhoe plc, a holding company listed on the UK stock exchange. Together with the finance director, you have held conversations with external consultants about accounting policy implementation issues. You have discussed a number of areas where the finance director believes the application of the requirements of an IFRS would not give a ‘true and fair view’ for users. The finance director has sent you the following extract from a note prepared by the consultants.

‘Accounting policies

It is essential that the accounting policies selected when implementing IFRS result in financial statements that give a fair presentation. The application of the principle of substance over form is integral in achieving this.

The choice of accounting policies is a matter of judgement and careful consideration is required particularly where you wish to override the requirements of an accounting standard.’

Tattanhoe plc’s UK subsidiaries prepare their financial statements in accordance with UK GAAP, but none of them are eligible to use the FRSSE. The UK Accounting Standards Board (ASB) approach to convergence will have a significant effect on the future accounting policies to be adopted by these subsidiaries.

The finance director wishes to discuss the above extract with you. He has a strong personality and he is adamant that non-compliance with IFRS may be justified where it does not give a true and fair view.

Requirements

(a) Prepare notes for your meeting with the finance director:

(i) Explaining the concept of ‘fair presentation’ and comparing it with ‘true and fair view’.

(ii) Explaining the concept of ‘substance over form’ and its relationship to ‘fair presentation’.

(iii) Explaining the circumstances in which non-compliance with the detailed provisions of an IFRS is justified.

(iv) Describing the ASB’s current proposals for convergence with IFRS and the reporting issues this will raise for Tattanhoe plc’s UK subsidiaries.

(b) Identify the ethical issues and actions, from the above scenario, that you should consider arising from the adoption of IFRS and your professional relationship with the finance director.

You are the financial controller of Darlat Ltd which currently prepares financial statements in accordance with UK GAAP. Your finance director has been in discussions with your corporate reporting advisors about whether to move to reporting under IFRS and has forwarded to you the following note received from them:

‘There are a number of differences between the UK GAAP and the IFRS recognition and measurement rules. Using information on our files, we have conducted a preliminary review of how your most recent financial statements might change if you had reported under IFRS. Below we show our estimate of the effect on equity at the end of the last year, together with brief notes on the different rules.'
Equity as reported under UK GAAP

<table>
<thead>
<tr>
<th>Adjustment</th>
<th>£'000</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity as reported under UK GAAP</td>
<td>6,688</td>
<td></td>
</tr>
<tr>
<td>Adjustments:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortisation of goodwill acquired in business combination</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Valuation of property measured under revaluation model</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>Depreciation thereof</td>
<td>(350)</td>
<td>850</td>
</tr>
<tr>
<td>Development expenditure</td>
<td>180</td>
<td></td>
</tr>
<tr>
<td>Amortisation thereof</td>
<td>(40)</td>
<td>140</td>
</tr>
<tr>
<td>Equity as reported under IFRS</td>
<td></td>
<td>7,928</td>
</tr>
</tbody>
</table>

Existing UK GAAP is now being replaced by FRS 102. As you are not eligible to use the FRSSE, you have the option to report under FRS 102 or under IFRS.

The following table shows the effect of this reporting move on recognition and measurement.

<table>
<thead>
<tr>
<th>Recognition and measurement rules</th>
<th>Old UK GAAP</th>
<th>New UK GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>You, like most UK companies, amortise goodwill over 20 years</td>
<td>Goodwill should normally be amortised over five years</td>
<td>Goodwill amortisation is prohibited</td>
</tr>
<tr>
<td>Property – revaluation model – basis of valuation</td>
<td>Existing use value, that is taking into account what you use it for</td>
<td>Fair value, that is the open market value taking account of all possible uses</td>
<td>Fair value, that is the open market value taking account of all possible uses</td>
</tr>
<tr>
<td>Development expenditure</td>
<td>You, like most UK companies, choose to write off development expenditure as incurred</td>
<td>You will still have the choice of whether to capitalise or write off</td>
<td>Recognition as an asset is compulsory when certain conditions are met</td>
</tr>
</tbody>
</table>

We would like to discuss these issues with you at an early date.'

Your finance director is aware that those making economic decisions use financial information for various purposes, including for the assessment of financial performance. He is pleased that the introduction of IFRS increases equity, remarking: 'if equity increases, then profit must increase both in the year of change and in future years. This will improve our performance. Shouldn’t we move to IFRS as soon as possible?'

**Requirement**

In advance of a meeting with your finance director to discuss his remarks, prepare bullet-point notes about the likely effect on performance if Darlat Ltd adopts IFRS.

*(8 marks)*

Now go back to the Learning objectives in the Introduction. If you are satisfied you have achieved these objectives, please tick them off.
Point to note: The whole of the Conceptual Framework and Preface to International Financial Reporting Standards is examinable. The paragraphs listed below are the key references you should be familiar with.

1 What is financial reporting?
- Financial reporting is the provision of financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.
- Financial statements comprise statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows and notes.

2 Purpose and use of financial statements
- Users’ core need is for information for making economic decisions.
- Objective is to provide information on financial position (the entity’s economic resources and the claims against it) and about transactions and other events that change those resources and claims.
- Financial position:
  - Resources and claims
  - Help identify entity’s strengths and weaknesses
  - Liquidity and solvency
- Changes in economic resources and claims:
  - Help assess prospects for future cash flows.
  - How well have management made efficient and effective use of the resources.
- Financial performance reflected by accrual accounting.
- Financial performance reflected by past cash flows.

3 Qualitative characteristics of useful financial information
- Two fundamental qualitative characteristics are relevance and faithful representation.
- Relevance = capable of making a difference to decisions
  - Predictive and confirmatory values
  - Materiality
- Faithful representation
  - Complete, neutral and free from error
- Four enhancing qualitative characteristics
  - Comparability, verifiability, timeliness and understandability

4 Cost constraint on useful financial reporting
- Costs (of preparing and analysing) financial information must be justified by the benefits of reporting it.

5 Underlying assumption
- Going concern
6 Elements of financial statements

- **Asset**: A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. *Concept Frame (4.4)*

- **Liability**: A present obligation of the entity arising from past events, the settlement of which is expected to lead to the outflow from the entity of resources embodying economic benefits. *Concept Frame (4.4)*

- **Equity**: The residual interest in assets less liabilities, that is net assets. *Concept Frame (4.4)*

- **Income** (comprising revenue and gains): Increases in economic benefits in the form of asset increases/liability decreases, other than contributions from equity. *Concept Frame (4.25, 4.29)*

- **Expenses** (including losses): Decreases in economic benefits in the form of asset decreases/liability increases, other than distributions to equity. *Concept Frame (4.25, 4.33)*

7 Recognition

- An asset or a liability should be recognised in financial statements if:
  - It is probable that any future economic benefits associated with the item will flow to or from the entity, and
  - Its cost or value can be measured with reliability. *Concept Frame (4.38)*

8 Measurement

- Historical cost *Concept Frame (4.55)*
- Current cost
- Realisable value
- Present value

9 Capital maintenance

- **Financial capital**:
  - Monetary
  - Constant purchasing power
- **Physical capital**

10 IASB

- Objectives of IASB
- Scope and authority of IFRS
- Due process re IFRS development *Preface (6)*, *Preface (7-16)*, *Preface (17)*

11 Fair presentation

- Financial statements are required to give a fair presentation of the financial position, financial performance and cash flows of an entity. *IAS 1 (15)*

  In the UK financial statements must present a true and fair view. *CA 2006*

12 Not-for-profit entities

- Regulated by:
  - Local legislation
  - SORPs
  - IPSAS
- Wording and format of IAS 1 financial statements may not be suitable for not-for-profit entities. *IAS 1 (5)*
Answers to Interactive questions

Answer to Interactive question 1

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
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<tbody>
<tr>
<td>(a) Oak plc has purchased a patent for £40,000. The patent gives the company sole use of a particular manufacturing process which will save £6,000 a year for the next five years.</td>
<td>This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost saving).</td>
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<td>(b) Elm plc paid John Brown £20,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.</td>
<td>This cannot be classed as an asset. Elm plc has no control over the car repair shop and it is difficult to argue that there are future economic benefits.</td>
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<tr>
<td>(c) Sycamore plc provides a warranty with every washing machine sold.</td>
<td>This is a liability. The business has an obligation to fulfil the terms of the warranty. The liability would be recognised when the warranty is issued rather than when a claim is made.</td>
</tr>
</tbody>
</table>

Answer to Interactive question 2

- Charities
- Friendly societies
- Public sector hospitals
- Public sector schools
- Clubs
- Associations
- Local councils
- Public services
- Trade unions
- Societies
- Housing associations
- Colleges

Answer to Interactive question 3

Key fundamental principles

Professional competence and due care – Do you have the necessary skills and experience to undertake the work?

Professional behaviour – How should you proceed so as not to discredit yourself?

Discussion

Identify relevant facts: Consider the business’ policies, procedures and guidelines, accounting standards, best practice, Code of Ethics, applicable laws and regulations. Can you demonstrate your lack of expertise in this area, the potential impact on the organisation and offer alternatives? Can you make reference to the Institute’s professional values and disciplinary process?

Identify affected parties: Key affected parties are you and your employer. Other possible affected parties are the human resources, internal audit, external auditors, shareholders and financial backers.

Who would be involved in resolution? Consider not just who should be involved but also for what reason and the timing of their involvement. Have you thought of contacting the Institute for advice and guidance? Do you have a trusted colleague with whom you can discuss your position? At what point will you consider involving the next level of management and human resources?
Possible course of action

Discuss your lack of expertise with your employer and suggest clearly defining the scope of the project and a course of action for addressing this issue, for example employing a person with the necessary expertise.

During the discussion, focus on the potential consequences to both the business and you personally of undertaking this project.

Explain that employing a person with the necessary expertise does not remove your obligation to ensure that the work is conducted in accordance with accounting standards, laws and regulations.

If your employer does not agree to the suggested course of action, it may be appropriate to discuss the matter with the next level of management.

If the response from management is not satisfactory, it may be necessary to involve the human resources department, the internal audit team or the Board.

During the resolution process it may be helpful to document your involvement, the substance of the discussions held, who else was involved, what decisions were made and why.
Answers to Self-test

1. Neither the intention nor the need to liquidate or curtail materially the scale of its operations.
2. It should be complete, neutral and free from error.
3. Has the move towards global accounting standards been successful?
   The move towards global accounting standards has taken great strides in the last decade. International accounting standards themselves have improved, with the elimination of contradictory alternatives and the creation of an open and independent standard setting organisation. This in turn has led to greater acceptance of these standards, particularly in 2005 with the compulsory adoption of IFRS for consolidated financial statements by all quoted companies in the EU.

   Since the EU successes there has been further progress on general global convergence. The IASB and the US FASB have been involved in the development of a common conceptual framework. There is also a Memorandum of Understanding between the IASB and FASB in respect of IFRS/US GAAP convergence. This has led to a number of short-term convergence projects between IFRS and US GAAP aimed to reduce differences in accounting practice such as the revised version of IAS 23 Borrowing Costs, which brings the IFRS more into line with the US method of capitalising appropriate borrowing costs. Progress has been such that non-US companies listed in the US no longer have to reconcile profit and equity in their IFRS financial statements to the equivalent figures under US GAAP.

   The Securities and Exchange Commission (the US regulator) has published proposals (in the form of a ‘roadmap’) under which, subject to satisfactory progress being made in a number of areas, it would become compulsory in 2015 or 2016 for US entities to adopt IFRS in place of US GAAP. However progress on this has slowed in recent years.

   Also, there is no global system of enforcement, and so it is too early to say if IFRS are being adopted properly. Some countries with their own highly developed accounting standards see the adoption of IFRS as a backward step, whereas other countries see IFRS as unnecessarily complicated.

   There is also the assumption that the globalisation of accounting standards is a good thing. Recent developments in IFRS have focussed on quoted companies in the western world; they may not be suitable for all types and sizes of business organisation, or for all stages of economic development.

4. TRADITIONAL FRUITS LTD
   (a) Potential providers of finance
   • The existing shareholders of the company and potential new shareholders – through a new issue of share capital.
   • Existing and future lenders and creditors to the company.

   Information requirements
   • The profit before interest of Traditional Fruits Ltd (TF Ltd), to determine risk.
   • The trend of profitability of TF Ltd together with a history of dividend payments. This will enable them to assess return and risk of their investment.
   • The financial structure of TF Ltd, to determine the level of debt finance as a measure of risk.
   • TF Ltd’s liquidity or ability to pay out dividends and redeem share capital.
   • TF Ltd’s ability to generate cash and the timing and certainty of its generation.
   • The liquidity of TF Ltd and its ability to repay interest and capital instalments.
   • The existing level of debt and any security over that debt.
(b) **Performance and position and the financial statements which assist in evaluation**

**Performance**
The financial performance of a company comprises the return it obtains on the resources it controls. Performance can be measured in terms of the profits of the company and its ability to generate cash flows.

Management will be assessed on their skill in achieving the highest level of performance, given the resources available to them.

Information on performance can be found in
- The statement of profit or loss and other comprehensive income.
- The statement of changes in equity.
- The statement of cash flows.

**Position**
The financial position of the company is evaluated by reference to:
(i) Its economic resources and claims.
(ii) Its capital structure, ie its level of debt finance and shareholders' funds.
(iii) Its liquidity and solvency.

The user of the financial statements can then make assessments on the level of risk, ability to generate cash, the likely distribution of this cash and the ability of the company to adapt to changing circumstances.

The statement of financial position is the prime source of information on a company’s position but the statement of cash flows will also indicate a company’s cash position over a period of time.

(c) **Financial statements – inherent limitations as a tool of decision-making**

Financial statements are prepared by reference to a relatively rigid set of accounting standards applicable to all companies, regardless of the sectors of the economy they operate in. As a result, information for individual and specialised companies may not be forthcoming. Further, the preparation of financial statements is based on estimates and judgements by the management and therefore are not a source of totally verifiable information.

Financial statements primarily use the historical cost convention. They can identify trends from the past which may be relevant to the future, but they are not forecasts and are therefore less helpful when making predictions.

In deciding whether or not to invest in a company, a decision-maker will also want access to non-financial data not contained in the financial statements such as
(i) A discussion of business risks and opportunities.
(ii) An evaluation of the quality of management.
(iii) A narrative analysis of position and performance.

5 **DAVIES AND SAYERS LTD**

(a) **Terms**

**Asset**
An asset is:
(i) A resource controlled by the entity
(ii) As a result of past events, and
(iii) From which future economic benefits are expected to flow into the entity.

Legal ownership is not an essential part of the definition of an asset, even though such ownership is indicative that the control criterion has been met. But the key is whether the entity controls a resource, so having the continued use of an item will often be sufficient evidence of control.

**Liability**
A liability is
(i) A present obligation of the entity
(ii) Arising from past events
(iii) The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

An obligation arises from a legally-enforceable contract, but it may also result from an entity’s normal business practices.

Recognised
Recognition means that an item is recorded in the financial statements. An asset or liability is recognised if

(i) It is probable that any future economic benefit associated with the item will flow to or from the entity, and

(ii) The cost or value can be measured with reliability.

(b) Notes for Carol Roberts

(1) Value of head of publishing

Existence of an asset

If you apply the definition of an asset from the Conceptual Framework to the head of publishing, Jane Lindsay, it is possible to argue that she has the characteristics of an asset.

As a full-time employee, Jane is likely to have a contract which was signed prior to the end of the reporting period. The legal contract will prevent Jane working for any other company, giving D&S Ltd unrestricted access to any benefits she may provide.

If Jane is able to persuade new authors to join the D&S team, she is creating a flow of future economic benefits – on the assumption that the authors’ new work will prove salesworthy.

However, there is uncertainty over

(i) The enforceability of Jane’s contract: she may recruit new authors to D&S Ltd, but within a short period of time might leave and join a new company; her authors are then likely to follow her.

(ii) The revenue stream to result from the new authors: they have not as yet been recruited and it is only possible that they will be; there are also no guarantees as to the quality of their future work and therefore the level of revenue they are likely to generate.

Therefore, at this stage we cannot conclude that an asset exists.

Recognition of the asset

An item is recognised when it is included in the financial statements at a monetary value. Carol Roberts is proposing to include Jane Lindsay as an asset in the statement of financial position. However, certain criteria should be applied prior to recognition.

(i) Is there sufficient evidence of the existence of the asset?

(ii) Can the asset be measured at a monetary amount with sufficient reliability?

(2) Provision for breach of copyright

Existence of a liability

At this stage Poppy Anderson has been accused of breach of copyright. From the information given, there is no opinion from lawyers as to the strength of the case or estimate of the possible value of any claim. Therefore, whilst a past transaction has allegedly occurred, there is insufficient evidence of, and uncertainty over, whether an obligation exists.

Recognition of the liability

To recognise the liability in the financial statements there must be sufficient evidence of the existence of the liability and it should be probable that economic benefit will flow from the entity. In this case, there is insufficient evidence of a liability and we are unable to reliably measure any potential liability.

The case is at far too early a stage to estimate the possible loss. It would therefore be over-prudent and inappropriate to recognise the liability in the financial statements.
(a) Notes for meeting

(i) Fair presentation and true and fair view

IAS 1 *Presentation of Financial Statements* describes the concept of fair presentation. Fair presentation involves representing faithfully the effect of transactions, other events and conditions in accordance with the definitions and recognition criteria in the Conceptual Framework.

This is developed by stating that the application of IFRS, interpretations and additional disclosures will result in fair presentation.

The traditional UK approach required financial statements to comply with the Companies Act (and therefore UK standards) and give a true and fair view. True could be approximated to ‘represent faithfully’ and fair to ‘fair presentation’. IAS 1 links them by stating that compliance with standards will give a fair presentation. As a result there is unlikely to be any difference between the two.

(ii) Substance over form and fair presentation

Most transactions are reasonably straightforward and their substance (their commercial effect) is the same as their legal form. In some complex transactions the true substance may not be readily apparent. Their legal form may not adequately express the true commercial effect of such transactions.

Where this is the case, it may not be sufficient to account for them by merely recording their form. The financial statements should represent commercial substance, not just legal form (substance over form). If a transaction gives rise to an asset or liability (as defined in the Conceptual Framework), it should be accounted for on this basis even if this is different from its legal form. Applying the definitions of an asset and a liability identifies the appropriate accounting treatment.

The Conceptual Framework identifies faithful representation as one of the two fundamental qualitative characteristics of useful financial information. If information is to represent faithfully the transactions it purports to represent, then they should be accounted for in accordance with their substance and economic reality and not merely their legal form. The substance may not be consistent with the legal form of a transaction. An example is a sale and repurchase agreement.

(iii) Non-compliance with IFRS

IAS 1 allows non-compliance with a standard (or interpretation) only where management concludes that compliance would be so misleading as to conflict with the objectives of financial statements set out in the Conceptual Framework. However this is only where the relevant regulatory framework requires, or does not prohibit, such a departure.

The standard uses the phrase ‘where management concludes’ which may indicate that there is a margin for those preparing the financial statements to use this exception where they believe it is appropriate. However, IAS 1 talks about this coming about ‘in extremely rare circumstances’. To all intents and purposes, these circumstances will never occur.

Inappropriate accounting policies or non-compliance are not rectified by disclosure of the policies adopted or by description in the notes to the financial statements.

The true and fair override is a UK concept and not permitted under IFRSs.

(iv) Convergence proposals and practical implications

FRS 100, FRS 101 and FRS 102 have now been issued with the intention of bringing financial reporting for UK companies into line with IFRS.

Because none of the subsidiaries can use the FRSSE, they will be affected by the new standards as follows:

- They may be able to report under the Reduced Disclosure Framework set out in FRS 101.
- As an alternative they will be able to report under FRS 102 based upon the IASB’s IFRS for SMEs.
This will require all the subsidiaries to change their reporting processes from UK GAAP to IFRS. New systems will be necessary, with implications for IT and staff training.

(b) **Issues and actions**

The Finance Director has a strong personality. He may use his position to dominate. This may result in him exerting influence on those around him, including the financial controller, so they acquiesce to his requirements.

Whilst IFRS narrow down the range of possible alternatives, the adoption of accounting policies still requires judgement and much is left to the discretion of management. It is essential that accounting policy selections generate information that is free from bias and presents faithfully the substance of the transactions.

The financial controller needs to use his professional skills and judgement. It may be appropriate to consult the Code of Ethics, the local district society for confidential support or to take advice from the ethical help lines offered by the ICAEW.

7 DARLAT LTD

**Notes for meeting with FD**

**Subject:** Performance measurement under IFRS  
**Prepared by:** Financial controller  
**Date:** xx/xx/xx

- Comparability is one of the qualitative characteristics which makes financial statement information useful.
- Changing from one set of accounting rules to another will make the FRS 102 or IFRS figures for the current year not comparable with the UK GAAP figures for the previous year.
- Normal comparability rules require restatement of the previous period under IFRS or FRS 102, so the previous period equity will probably increase as well.
- So performance in the current year may not be assessed as having improved.
- Financial statement users have three key measures: cash flow, profitability and gearing
  - Cash flow: cash flows are unaltered by changing recognition/measurement rules for assets and liabilities in the statement of financial position.
    - No performance improvement (no change at all).
  - Profitability: increase in equity = increase in capital employed, so, other things being equal, ROCE (profit before interest and tax as % of (equity and interest-bearing liabilities)) will go down, not up.
    - Profit will go up as a result of no goodwill amortisation if IFRS is adopted. However it should be reviewed for impairment.
    - Under FRS 102 amortisation will normally be over a shorter period and goodwill should still be reviewed for impairment. This could reduce profit.
    - Profit will go down as a result of higher property values – higher depreciation in future years.
    - It is not clear what effect recognising development expenditure as an asset will have in future years. Depreciation will go up, but perhaps by less than positive effect of capitalisation of expenditure written off under UK GAAP.
    - Net effect may be performance deterioration.
  - Gearing: equity goes up, but no change in interest-bearing liabilities. So gearing (interest-bearing liabilities as % of equity) goes down.
    - Improvement in performance