

REVISION NOTES

ACCA Paper F7

FINANCIAL REPORTING

FOR EXAMS IN 2014



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F7

CHAPTER 1

THE
CONCEPTUAL
FRAMEWORK

KEY LEARNING POINTS

- ▶ A conceptual framework is useful in a **principles-based** accounting system as it provides the principles on which accounting for transactions is based.
- ▶ A conceptual framework provides a theoretical basis for determining how transactions are accounted for. It ensures that transactions are dealt with **consistently**.
- ▶ Without a framework that provides the basic principles of accounting for transactions, there is a risk that a firefighting approach is taken. This means that standards are applied to a particular accounting issue and aimed at fixing that issue without considering the overall effect.
- ▶ There has been discussion as to whether there should be a **separate framework** for different types of users. For example, in the UK, the ASB has considered whether to issue a separate conceptual framework for public benefit entities as their focus is different from a trading entity
- ▶ In the US, the lack of a conceptual framework meant that very detailed, prescriptive accounting standards had to be produced.
- ▶ A rules-based approach is easier to circumvent than a principles-based approach.



TOPIC TIP

Make sure you understand **why** the conceptual framework exists and what **purpose** it fulfils. This was asked for when the topic was last examined in June 2006.



KEY LEARNING POINTS

- ▶ If an accounting treatment is to form part of GAAP:
 - It will be dealt with in an **accounting standard** or similar pronouncement.
 - It will be the accounting treatment applied by **other entities** in similar situations.
 - It will be consistent with the need to provide a **fair presentation** of the entity's results and position.
- ▶ As shown on the diagram on the prior page, GAAP signifies the rules from whatever source that govern accounting. This can be national company law, national accounting standards, stock exchange requirements and IFRSs.



KEY LEARNING POINTS

- ▶ The objective of financial statements is to provide information on the financial position, performance and changes in financial position of an entity that is useful to a **wide range of users** in making economic decisions (IAS 1).
- ▶ **Financial position** information is affected by the following and information about each one can aid the user.
 - **Economic resources controlled:** to predict the ability to generate cash
 - **Financial structure:** to predict borrowing needs, the distribution of future profits/cash and likely success in raising new finance
 - **Liquidity and solvency:** to predict whether financial commitments will be met as they fall due
- ▶ Information on the **financial performance of an entity** (income statement / statement of comprehensive income) is used to assess potential changes in the economic resources the entity is likely to control in future. Information about performance variability is therefore important.
- ▶ Information on the **changes in financial position** (ie statement of cash flows) is used to assess the entity's investing, financing and operating activities. They show the entity's ability to produce cash and the needs which utilise those cash flows.
- ▶ In the preparation of financial information there is an underlying assumption that must be considered: **going concern**.
 - **Going concern:** The entity is normally viewed as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.



KEY LEARNING POINTS

The fundamental qualitative characteristics are relevance and faithful representation.

- ▶ **Relevance:** Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Relevance is affected by materiality.
- ▶ **Materiality:** Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
- ▶ **Faithful representation:** Information is a faithful representation when it is complete, neutral and free from error and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

The **enhancing** qualitative characteristics are:

- ▶ **Comparability:** This enables users to identify and understand similarities in, and differences among, items.
- ▶ **Verifiability:** This assures users that information is a faithful representation.
- ▶ **Timeliness:** Information must be made available in time to influence the decisions of users.
- ▶ **Understandability:** Can be understood by users who have a reasonable knowledge of business and economic activities.



TOPIC TIP

In June 2011, candidates were asked to define and explain relevance.



KEY LEARNING POINTS

- › Transactions are grouped into broad classes within the financial statements, these are the elements of financial statements and include assets, liabilities, equity, income and expenses.
- › **Asset:** 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.
- › **Liability:** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- › **Equity:** The residual interest in the assets of the entity after deducting all its liabilities.
- › **Income:** Increases in economic benefits during the accounting period, other than those relating to contributions from equity participants.
- › **Expenses:** Decreases in economic benefits during the accounting period, other than those relating to distributions to equity participants.
- › Items can be recognised in the financial statements providing they meet the following criteria:
 - 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**.
- › A number of different **measurement bases** are used in financial statements, of which, historical cost is the most common. They include:
 - **Historical cost:** Assets and liabilities are recorded at the amount of paid / received to acquire them at the time of their acquisition.
 - **Current cost:** Assets and liabilities are carried at the amount of cash that would be required to acquire / settle the same asset or liability at the current time.
 - **Present value:** A current estimate of the present discounted value of the future net cash flows in the normal course of business.
 - **Realisable settlement value:** The amount of cash that could be obtained by selling an asset and the undiscounted amount of cash expected to be paid to satisfy the liabilities in the normal course of business.



TOPIC TIP

These are very important definitions and must be learnt. Exam questions often ask students to determine how a transaction should be accounted for by referring to the definitions of elements in the *Conceptual Framework*. This style of question was examined in December 2008 and June 2010.



KEY LEARNING POINTS

- Under **financial capital maintenance**, capital is the **net assets or equity of the entity**.
- Under **operating capital maintenance**, capital is regarded as the **productive capacity** of the entity.
- Financial** capital maintenance is used in **historical cost accounting**.
- Operating** (or **physical**) capital maintenance is used in **current cost accounting**.



TOPIC TIP

This is not a topic on which you need much detailed knowledge. It is covered more fully in Chapter 22.

CHAPTER 2

THE REGULATORY FRAMEWORK



KEY LEARNING POINTS

-) The formal objectives of the IASB are:
 - To develop, in the public interest, a single set of **high quality, understandable and enforceable global accounting standards** that require high quality, transparent and comparable information in general purpose financial statements.
 - To provide the **use and vigorous application** of those standards.
 - To work actively with national accounting standard setters to bring about **convergence** of national accounting standards and IFRSs.
-) The main regulatory bodies are:
 - **IFRS Foundation** who appoint members of the IASB, Standards Advisory Council and International Financial Reporting Interpretations Committee.
 - **International Accounting Standards Board** whose primary role is the setting of international accounting standards.
 - **IFRS Advisory Council** who give advice to the IASB on work priorities and the implications of proposed accounting standards.
 - **IFRS Interpretations Committee** who provide guidance on the application and interpretation of IFRSs, dealing with issues not dealt with in the standards or where unsatisfactory interpretations have developed.



KEY LEARNING POINTS

- ▶ In order for the adoption of IFRSs to be successful, the IASB needs to have a good relationship with **national standard setters** such as the ASB in the UK, or FASB in the US.
- ▶ Seven of the full-time members of the IASB have formal liaison responsibilities with national standard setters in order to **promote the convergence** of national accounting standards.
- ▶ The scope of an IFRSs is clearly stated at the beginning of the standard. Because local regulations exist in individual countries, the aim is that **IFRSs are not too complex** so they can be adopted by different countries on a worldwide basis.



TOPIC TIP

The June 2012 paper had a question on the advantages of adopting IFRS.



KEY LEARNING POINTS

- ▶ Many old IASs permitted **more than one accounting treatment**. An example of this is IAS 23 *Borrowing costs* which allowed a choice of either writing off or capitalising qualifying finance costs incurred on the construction of a non-current asset.
- ▶ Recent developments in accounting standards have sought **to eliminate these choices** and IAS 23 has recently been amended so that there is no longer a choice and qualifying finance costs are now to be capitalised.
- ▶ Certain standards are seen to be **complex and very prescriptive** in their nature. This in particular has been a criticism of IAS 39 *Financial instruments: recognition and measurement* which is a very long and complex accounting standard. The difficulty is that accounting for financial instruments is a very complex topic and needs detailed rules for effective treatment in the financial statements. It can be difficult to obtain a balance between the necessity for an accounting standard to cover a topic in sufficient detail and the understandability of that standard. IFRS 9 has now been issued to simplify the treatment of financial assets and liabilities but is still very detailed due to the nature of financial instruments.

CHAPTER 3

PRESENTATION OF PUBLISHED FINANCIAL STATEMENTS



KEY LEARNING POINTS

- The statement of financial position shows the **financial position** of an entity.
- Assets are totalled in the top half and equity and liabilities in the bottom half.



TOPIC TIP

- The statement of financial position will be examined in either Q1 or Q2 of the exam, the group accounting question and / or the published financial statements question.
- Students must be very familiar with the format.



KEY LEARNING POINTS

- ▶ The statement of comprehensive income can be presented as a **single statement** as illustrated here or **two separate statements** – a statement of profit or loss and a separate statement of other comprehensive income.
- ▶ IAS 1 defines **other comprehensive income** as 'items of income and expenses that are **not recognised in profit or loss** as required or permitted by other IFRSs'.
- ▶ The components of other comprehensive income that are in the F7 syllabus are changes in **revaluation surpluses** and gains or losses on **remeasurement of equity** financial assets as both these items are recognised directly in reserves.
- ▶ The recognition and measurement of items in the statement of profit or loss and other comprehensive income has not changed, it is only the **presentation** of these items.



TOPIC TIP

- ▶ The statement of profit or loss and other comprehensive income could be examined in the group accounting question (Q1) or the published financial statements question (Q2). In June and December 2009 it was examined in Q2.
- ▶ In the comprehensive income section you may see gains or losses on revaluation of non-current assets or gains and losses on financial instruments that have been recognised in reserves.



KEY LEARNING POINTS

- ▶ The SOCIE shows the **owner changes in equity** in the period.
- ▶ Comprehensive income from the SOCI is shown as a **single line item** rather than being split into its components.



TOPIC TIP

Occasionally this is asked for as part of the published accounts question (Q2).



KEY LEARNING POINTS

- › The **operating cycle** of an entity is the time between the acquisition of materials entering into a process and its realisation into cash or an instrument that is readily convertible into cash.
- › Current assets include **inventories** and **receivables** that are sold as part of the normal operating cycle of the entity.
- › They are classified as current assets even if they are **not expected to be realised** within the next twelve months.
- › An entity whose financial statements comply with IFRSs must make a **statement** of this fact in the notes to the financial statements. The financial statements must **comply with all the requirements** of IFRSs.
- › Financial statements are deemed to show a **fair presentation** if all IFRSs are complied with.



TOPIC TIP

In the published accounts question (Q2) students are often given a trial balance and asked to prepare a set of financial statements so they need to know how items are classified.

CHAPTER 4

NON-CURRENT ASSETS



KEY LEARNING POINTS

- › Initial recognition of an asset is at **cost plus all other costs** of getting the asset to its present location and condition.
- › **Subsequent expenditure** can be capitalised if it is probable that future economic benefits will flow to the entity and the cost can be measured reliably. Usually this expenditure has to enhance the assets above and beyond what was originally recognised.
- › Assets can be subsequently measured at **cost or revaluation** – it is an accounting policy choice.
- › If assets are held at revalued amounts, **all assets of the same class must be revalued** and the revaluations must be kept up to date.
- › A **revaluation surplus** is an unrealised gain and cannot be recognised in the income statement, so it is recorded in the **revaluation surplus** and disclosed as **other comprehensive income** in the statement of comprehensive income
- › The double entry to record a **revaluation increase** is:
 DR Non-current assets – cost (the difference between valuation and original cost)
 DR Accumulated depreciation (to remove the existing depreciation provision)
 CR Revaluation surplus (the difference between new value and old carrying value)
- › After the revaluation takes place the asset is depreciated at valuation over its **remaining useful life**.
- › A revaluation surplus **increases the depreciation expense** so the additional depreciation charged compared to that based on historic cost becomes realised and is transferred from the revaluation surplus to retained earnings each year.



TOPIC TIP

Non-current assets are examined in some form in every exam paper. In particular they are dealt with in the published accounts question (Q2). In the December 2008 and June 2009 exams Q5 was a fairly complicated question on non-current assets.



KEY LEARNING POINTS

- › A surplus on revaluation is recognised in the **revaluation surplus** and as part of 'other comprehensive income'.
- › A **decrease in the value of a revalued asset** can be taken to the revaluation surplus for that same asset until it is reversed and then any further loss is recognised in the income statement.
- › The decrease in value of an **asset held at cost** is recognised in the income statement.



KEY LEARNING POINTS

- › A **government grant** is provided to an entity to assist with a particular item of expenditure or for the purchase of a non-current asset.
- › Capital expenditure grants have **two permitted accounting treatments**:
 - Deduct the grant from the cost of the asset
 - Set up the grant as deferred income and release to the income statement over the period the related asset is depreciated



KEY LEARNING POINTS

- › Investment property is property held to **earn rentals or for capital appreciation or both** rather than for use in the production or supply of goods and services or for sale in the ordinary course of business.
- › Examples include land held for capital appreciation, a building leased out under an operating lease.
- › Property that is not investment property includes property intended for sale in the ordinary course of business, property being constructed or developed on behalf of third parties and owner occupied property.
- › Investment property is **initially measured at cost**.
- › There is a choice of subsequent measurement:
 - **Cost model** – investment property is accounted for under IAS 16 at depreciated cost less impairment losses
 - **Fair value model** – investment property is measured at fair value with gains or losses recognised in the income statement



KEY LEARNING POINTS

- › Borrowing costs are **interest and other costs** incurred by an entity in connection with the borrowing of funds.
- › IAS 23 states that borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset form part of the cost of that asset.
- › A **qualifying asset** is one that takes a substantial period of time to get ready for its intended use or sale.
- › The borrowing costs that should be capitalised are those that would have been **avoided** had the expenditure on the qualifying asset not been made.
- › Capitalisation **commences** when the entity begins expenditure on the asset, incurs borrowing costs and necessary activities are taking place to prepare the asset for its intended use.
- › Capitalisation of borrowing costs should be **suspended** if construction is interrupted for extended periods and capitalisation should **cease** when construction of the asset is complete.
- › If **general funds** are borrowed and partly applied to the construction of an asset then the amount to be capitalised is calculated by applying the **weighted average rate** of borrowing costs to the expenditure on the asset, providing it doesn't exceed actual costs incurred.



TOPIC TIP

The June 2010 exam had a 10-mark question on borrowing costs.

CHAPTER 5

INTANGIBLE ASSETS



KEY LEARNING POINTS

- › An intangible asset is an **identifiable non-monetary asset without physical substance** such as computer software, patents, copyrights, franchises and fishing rights.
- › An intangible asset must be **identifiable** in order to distinguish it from goodwill. If an intangible asset is purchased separately then it will be separable – capable of being sold separately.
- › An intangible asset is **initially recognised at cost** provided that it is probable that future economic benefits will flow to the entity and the cost can be measured reliably.
- › **Internally generated goodwill** cannot be recognised as an asset, only purchased goodwill is permitted to be recognised.
- › **Research expenditure** must be written off as an expense in the income statement as there is too much uncertainty about the outcome of a project at the research stage.
- › **Development expenditure** may qualify for capitalisation providing it meets the following criteria:
 - Adequate resources exist to complete and use or sell the asset
 - The technical feasibility of completing the intangible asset so it will be available for use or sale
 - The intention to complete the intangible asset and use or sell it
 - The ability to use or sell the intangible asset
 - How the intangible asset will generate probable future economic benefits
 - The ability to measure the development expenditure reliably
- › Other **internally generated intangible assets** such as brands, mastheads publishing titles and customer lists cannot be recognised.



TOPIC TIP

The key intangible asset dealt with in the exam is goodwill on acquisition which is examined in Q1. Development expenditure was examined in December 2008.

Use the PIRATE mnemonic on the diagram.



KEY LEARNING POINTS

- › Intangible assets should be **initially measured at cost**, but can be subsequently measured at **cost or revaluation**.
- › The **cost model** requires intangibles to be recognised at cost less accumulated amortisation.
- › The **revaluation model** allows intangibles to be carried at a revalued amount less amortisation.
- › As many intangible assets do not have an active market, the revaluation model may not be available.
- › Intangible assets should be **amortised** over their useful life.
- › If an intangible asset has an **indefinite useful life** then it should not be amortised but tested for impairment at least annually.



KEY LEARNING POINTS

- › Goodwill is created from good relationships between a business and its customers. It cannot be recognised unless a business is sold.
- › **Purchased goodwill** is the difference between the purchase consideration for the business and the fair value of net assets acquired.
- › Goodwill on acquisition is recognised as an **intangible asset** at cost less any accumulated impairment losses.
- › **Negative goodwill** arises when the cost of investment is less than the fair value of net assets acquired. It is recognised immediately in profit or loss.



TOPIC TIP

Goodwill is a key area and students must be able to calculate goodwill on acquisition as part of the group accounting question.

CHAPTER 6

IMPAIRMENT OF ASSETS



KEY LEARNING POINTS

- › An asset is impaired if its **recoverable amount is lower than its carrying value** in the statement of financial position.
- › Recoverable amount is the **greater of fair value less costs to sell and value in use.**
- › **Fair value less costs to sell** is the selling price of the asset in an arm's length transaction less disposal proceeds or costs.
- › **Value in use** is the present value of future cash flows generated by the asset including its eventual disposal costs.
- › If an asset is impaired then it needs to be **written down** to its recoverable amount.
- › At each reporting date, an entity should assess whether there are any **indicators of impairment** for any asset. If so, an impairment review should be carried out.



TOPIC TIP

Impairment can be examined as a discussion question and students must be able to discuss the definition of impairment and the indicators of impairment as well as apply the knowledge to a specific scenario. The June 2012 paper had a 15-mark question on IAS 36.



KEY LEARNING POINTS

- ▶ If the recoverable amount of an individual asset cannot be calculated then the recoverable amount of the **cash generating unit** to which the asset belongs should be calculated instead.
- ▶ A cash generating unit (CGU) is the **smallest identifiable group of assets** for which independent cash flows can be identified and measured. For example, for a restaurant chain a CGU might be each individual restaurant.
- ▶ As **goodwill** acquired in a business combination does not generate cash flows independently of other assets, it must be allocated to each of the acquirer's cash generating units.
- ▶ A CGU to which goodwill has been allocated is **tested for impairment annually**. The carrying amount of the CGU including the goodwill is compared with its recoverable amount.
- ▶ The **impairment loss on a CGU is allocated** in the following order:
 - First to any asset that is impaired (eg if an asset was specifically damaged)
 - Second, to goodwill in the cash generating unit
 - Third, to all other assets in the CGU on a *pro rata* basis based on carrying value
- ▶ When allocating an impairment loss the **carrying amount of an asset should not be reduced** below the higher of its fair value less costs to sell, value in use or zero.
- ▶ For assets that are held at **historical cost** the impairment loss is charged to profit or loss. For **revalued assets** the impairment is treated as a revaluation decrease.



TOPIC TIP

Allocation of impairments to cash generating units is a highly examinable topic and students need to understand the rules and method of doing this.



KEY LEARNING POINTS

- ▶ In some cases the recoverable amount of an asset that has previously been impaired might turn out to be higher than the assets' current carrying value – so some part of the impairment loss has been **reversed**.
- ▶ The accounting treatment is to **reverse the impairment loss in profit or loss** and restate the assets at their new recoverable amount.
- ▶ The exception to this rule is **goodwill** which can never have a previous impairment loss reversed.

CHAPTER 7

REPORTING FINANCIAL PERFORMANCE



KEY LEARNING POINTS

- › Accounting policies are determined by applying the relevant IFRS and applying judgement so that the accounting information provided is **relevant and reliable**. Accounting policies should be selected on a **consistent** basis in order that financial information is comparable.
- › A **change in accounting policy is rare** and tends to occur if a new accounting standard is issued or an existing standard is amended or if the change will result in a fairer presentation of events and transactions in the financial statements of the entity.
- › A **change in accounting policy is applied retrospectively** so that the financial statements look as if the new policy had always been in existence. The opening retained earnings are restated as well as the comparative figures. The net effect of the change in accounting policy can be seen in the statement of changes in equity when the opening balances are restated.



KEY LEARNING POINTS

- › There will always be transactions within the financial statements that have uncertainties surrounding them. In accounting for these items, **judgement** has to be used in ensuring an appropriate amount is recognised. Examples of accounting estimates include allowances for receivables, useful lives of depreciable assets, provisions for obsolescence of inventory and provisions for warranties.
- › The effect of a **change in accounting estimate should be included in the current period** and future periods as necessary. It is not adjusted retrospectively, but prospectively.
- › A **prior period error** may arise through mistakes in the accounting process, oversights or frauds. If the error is material and relates to the prior period it should be accounted for **retrospectively** in the same way as a change in accounting policy.



KEY LEARNING POINTS

- › IFRS 5 requires assets that are **held for sale** to be presented separately on the face of the statement of financial position and the **results of discontinued operations** to be presented separately in the income statement.
- › The aim of presenting this information separately is so that users of the financial statement can make more **informed decisions** about the performance and future performance of an entity.



TOPIC TIP

IFRS 5 was examined as a 10-mark question in December 2010.



KEY LEARNING POINTS

- › A non-current asset or disposal group should be classified as **held for sale** if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. The assets must be **available for immediate sale** and its sale must be highly probable (criteria for highly probable on prior page).
- › Assets or disposal groups held for sale are measured at the **lower** of carrying amount and fair value less disposal costs.
- › An asset or disposal can still be classified as held for sale if the sale hasn't taken place within one year providing the delay has been caused by **events or circumstances beyond the entity's control** and there must be sufficient evidence the entity is still committed to sell the asset or disposal group.
- › If an entity acquires a **disposal group exclusively with a view to immediate resale** then it can classify it as held for sale providing it is expected to be sold within one year and the other criteria are met. This typically relates to a situation where a parent buys a group which contains subsidiaries that are not to be kept within the continuing business and are to be disposed of.

- ▶ An asset that is to be **abandoned** cannot be classified as held for sale.
- ▶ The **results of discontinued operations** are disclosed on the face of the statement of profit or loss in a single amount which comprises the total of:
 - The post-tax profit or loss of discontinued operations and
 - The post-tax gain or loss on the remeasurement to fair value less costs to sell
- ▶ An analysis of the single amount into revenue, expenses, profit before tax, tax and the gain or loss on the disposal or remeasurement of the assets is then disclosed in the notes (this presentation could alternatively be disclosed on the face of the statement).

CHAPTER 8

INTRODUCTION TO GROUPS



KEY LEARNING POINTS

- Many large businesses consist of several companies controlled by one central or administrative company. A **group of companies** consist of the controlling company, called the parent or **holding company**, who owns some or all of the shares in the other companies, called subsidiaries.
- The key factor in determining if there is a parent / subsidiary relationship is **control**. In most cases control is obtained when the parent company obtains a **majority** of the ordinary (voting) shares in another company. (This will be more than 50% of voting rights.)
- However there are certain circumstance where control can exist even if the parent owns less than half of the voting capital. These include:

 - The parent has power over more than 50% of the voting rights by virtue of **agreement with other investors**.
 - The parent has power to **govern the financial and operating policies** of the entity by statute or under an agreement.
 - The parent has the power to **appoint or remove a majority of members of the board of directors** (or equivalent governing body).
 - The parent has power to cast a **majority of votes at meetings of the board of directors**.
- As the parent controls its subsidiaries, this relationship is represented in the group accounts. IFRS 10 requires a parent to present **consolidated financial statements**, where the accounts of the parent and subsidiaries are combined and presented **as a single economic entity**.
- An **investment in an associate** is less than a subsidiary, but more than a simple investment. The key criterion is **significant influence**. This is defined as the 'power to participate', but not to 'control' (which would make the investment a subsidiary).
- Significant influence is usually assumed if a parent owns **20% or more** of the voting power of the associate, unless it can be clearly shown that this is not the case.
- Associates are **not consolidated** because the parent does not have control. Instead they are equity accounted, where the **parent's share** of income and net assets is recorded in the group accounts.



TOPIC TIP

Group accounting is examined every sitting as Q1. Often the questions have a 20-mark computational element and 5 marks of discussion about the principles of group accounting.



KEY LEARNING POINTS

- ▶ **All subsidiaries should be consolidated** unless they meet the criteria for exemption (on prior page). The criteria for exclusion are strict as an entity may wish manipulate their results and exclude a loss making subsidiary or one with high levels of debt as this affects the overall picture presented of the group.
- ▶ Some entities wish to exclude subsidiaries which have **differing activities** to the rest of the group as showing the results in the consolidation would be misleading. This is not permitted as additional information can be disclosed about the different business activities of the subsidiary (eg segmental reporting disclosures).
- ▶ Subsidiaries **held for sale** are accounted for in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations* (see Chapter 7).
- ▶ In most cases, all group companies will prepare accounts to the **same reporting date** but if this is not the case, a subsidiary can prepare financial statements to the reporting date of the group for consolidation purposes. If this isn't possible, the subsidiary's accounts can still be used for the consolidation, provided that the gap between the reporting dates is **three months or less**.
- ▶ Group accounts should be prepared using **the same accounting policies** for all member of a group. **Adjustments** must be made where members of a group use different accounting policies.
- ▶ The results of subsidiary undertakings are included in the consolidated financial statements from:

- The date of acquisition – the date control passes to the parent, to
 - The date of disposal – the date control passes from the parent.
- Group accounts consist of:
- **Parent company financial statements**, which will include 'investments in subsidiary undertakings' as an asset in the statement of financial position, and income from subsidiaries (dividends) in the statement of profit or loss and other comprehensive income.
 - **Consolidated statement of financial position.**
 - **Consolidated statement of profit or loss and other comprehensive income**
 - **Consolidated statement of cash flows.**
- F7 only requires the preparation of a consolidated statement of financial position and statement of profit or loss and other comprehensive income.

CHAPTER 9

THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION



KEY LEARNING POINTS

- ▶ The financial statements of a parent and its subsidiaries are **combined on a line-by-line basis** by adding together like items of assets, liabilities, equity, income and expenses
- ▶ The carrying amount of the parent's investment in each subsidiary is **cancelled** against the group's share of the fair value of the net assets of each subsidiary at the date of acquisition, the resulting balance being **goodwill**.
- ▶ Group retained earnings are calculated taking all of the parent's retained earnings and the group share of each subsidiary's **post-acquisition profits**, ie the profits earned since acquisition.
- ▶ Calculate the non-controlling interest's (NCI) share in the net assets of the subsidiaries as the NCI share of net assets at the reporting date.
- ▶ Add together the assets and liabilities of the parent with all of the assets and liabilities of the subsidiaries, eliminating any intercompany balances between the parent and subsidiaries.



TOPIC TIP

Consolidated accounts are examined each period and students must be very familiar with the layout and workings of the statement of financial position.



KEY LEARNING POINTS

- D In the previous Learning Example, the non-controlling interest was calculated using the 'traditional' method, valuing it at the NCI's share of net assets at the reporting date. IFRS 3 (revised) gives entities the option of **valuing non-controlling interest at fair value**. The thinking behind this is that the non-controlling interest, in purchasing their shares, also purchased goodwill in the subsidiary, and that the traditional method of consolidation does not show this goodwill.
- D IFRS 3 (revised) suggests that the closest approximation to fair value will be the **market price** of the shares held by non-controlling shareholders just before acquisition by the parent.
- D At the year end, the value of the non-controlling interest will be its value at acquisition, plus its share of the post-acquisition retained earnings of the subsidiary.
- D Any goodwill impairment will be allocated to the non-controlling interest in proportion to its holding in the subsidiary. This will be deducted from the total of the non-controlling interest at the year end.



TOPIC TIP

If students are required to use the fair value option, the question will state that this method should be used. They will be given either the share price of the subsidiary just before acquisition or told that the non-controlling interest is valued at a certain amount.

In the June 2009 exam candidates were given the fair value of the NCI. In the June 2010 exam they were told to use the share price.



KEY LEARNING POINTS

- ▶ As well as dealing with goodwill, non-controlling interest and group retained earnings, there are a number of other **adjustments** that must be dealt with such as elimination of unrealised profits, and removal of intercompany balances.
- ▶ Any **receivable/payable balances outstanding between the companies** are **cancelled** on consolidation. The balances must be reconciled before cancelling as they may not agree if cash has been paid by one party and not yet received by the other party. As well as current accounts, loans between parent and subsidiary are also cancelled.
- ▶ If there have been sales between parent and subsidiary and goods are still left in inventory, an adjustment must be made to remove the **unrealised profit** on the transaction so that the goods are in the group accounts at the cost to the group. The profit may be calculated using mark-up or gross margin percentages.
- ▶ When unrealised profit exists, it is important to ensure that the profit is eliminated in the accounts of the company that made the profit. If the **parent sold goods to the subsidiary** the journal to remove the unrealised profit is:

DR Group retained earnings

CR Group inventory (statement of financial position)

If the **subsidiary sold the goods**, the non-controlling interest must account for their share of the unrealised profit as follows:

DR Group retained earnings (Group share)

DR Non-controlling interest (NCI share)

CR Group inventory (statement of financial position)

- ▶ Unrealised profit can also arise on the **transfer of non-current assets** between group entities. The consolidated statement of financial position must show assets at their cost to the group, and any depreciation charged must be based on that cost. Two consolidation adjustments will usually be needed to achieve this.
 - An adjustment to alter retained earnings and non-current assets cost so as to **remove any element of unrealised profit or loss**. This is similar to the adjustment required in respect of unrealised profit in inventory.
 - An adjustment to alter retained earnings and accumulated depreciation is made so that consolidated **depreciation is based on the asset's cost to the group**.

As with unrealised profit on inventory, if the sale was made by the subsidiary, the non-controlling interest must account for their share of the unrealised profit.



KEY LEARNING POINTS

- Goodwill arising on consolidation is subjected to an annual impairment review and impairment may be expressed as an amount, eg "goodwill has been impaired by \$2m" or as a percentage, "goodwill has been impaired by 10%". The double entry to write off the impairment is:

DR Group retained earnings	CR Goodwill
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- When the non-controlling interest is valued at **fair value**, the goodwill in the statement of financial position includes goodwill attributable to the non-controlling interest. In this case the double entry will reflect the non-controlling interest proportion based on their shareholding as follows:

DR Group retained earnings (group %)	CR Goodwill
DR Non-controlling interest (NCI %)	
- If negative goodwill arises, IFRS 3 refers to this as a 'bargain purchase'. The accounting treatment is:

 - An entity should first **re-assess** the amounts at which it has measured both the cost of the combination and the acquiree's identifiable net assets. This exercise should **identify any errors**.
 - Any **excess remaining** should be **recognised immediately in profit or loss**.



KEY LEARNING POINTS

- IFRS 3 sets out **general principles** for arriving at the fair values of a subsidiary's assets and liabilities. The acquirer should recognise the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if they satisfy the following criteria:

 - In the case of an **asset** other than an intangible asset, it is **probable** that any associated **future economic benefits** will flow to the acquirer, and its fair value can be **measured reliably**.
 - In the case of a **liability** other than a contingent liability, it is probable that an **outflow** of resources embodying economic benefits will be required to settle the obligation, and its fair value can be **measured reliably**.
 - In the case of an **intangible asset** or a **contingent liability**, its fair value can be **measured reliably**.
- The acquiree's identifiable assets and liabilities might include assets and liabilities **not previously recognised** in the acquiree's financial statements, such as a deferred tax asset that the subsidiary could not utilise.
- An acquirer **should not recognise liabilities for future losses** or other costs expected to be incurred as a result of the business combination.
- The acquiree may have **intangible assets** which can only be recognised separately from goodwill if they are **identifiable**. They must be able to be capable of being separated from the entity.
- The acquirer should measure the cost of a business combination as the total of the **fair values**, at the date of exchange, **of assets given**, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree.

- If part of the consideration is payable at a later date, this deferred consideration is **discounted** to **present value** at the date of exchange.
- Where equity instruments (eg, ordinary shares) of a quoted entity form part of the cost of a combination, the **published price** at the date of exchange normally provides the best evidence of the instrument's fair value.
- Costs **attributable** to the combination, for example professional fees and administrative costs, should not be included: they are recognised as an expense when incurred.
- If an asset or liability has been recognised at fair value at acquisition, and it is still owned at the reporting date and the adjustment has not been reported in the subsidiary's accounts, it must be recorded in the statement of financial position at fair value.
- Some fair value adjustments are made on depreciable assets such as buildings. In the periods after acquisition, the asset must be depreciated at its fair value so there will be an adjustment, which flows through to profit or loss for this additional depreciation.

CHAPTER 10

THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME



KEY LEARNING POINTS

- ▶ There are a number of adjustments that have been made in the consolidated statement of financial position that flow through to the statement of profit or loss.
- ▶ If there has been an **impairment of goodwill** in the period, this will need to be charged as an expense. It is usually taken to administration expenses but check the question carefully as the examiner may state where it is to be recorded
- ▶ If there is **unrealised profit** on sales between group members then this needs to be eliminated as the unrealised profit will be included in closing inventory. Make sure the flow of the transaction is recorded correctly as, if the subsidiary made the sale, the unrealised profit will affect the non-controlling interest.
- ▶ If there have been **fair value adjustments on depreciable assets** then the additional depreciation will be expensed. The question will state the remaining life of assets or the depreciation method and where the expense should be recognised.
- ▶ Any **intercompany transfer of non-current assets** will also need to be dealt with in the statement of profit or loss. If the transfer occurred during the current year then the profit should be eliminated, and the asset should be depreciated at the cost to the group so there will be a depreciation add back to adjust.



TOPIC TIP

The consolidated statement of profit or loss tends to be easier to deal with than a consolidated statement of financial position and is less frequently examined. It is often examined with the consolidated statement of financial position.



KEY LEARNING POINTS

- › Preparing the consolidated statement of profit or loss involves **adding together** the income and expenses of the parent and subsidiaries from **revenue down to profit for the year**.
- › The consolidated figures for sales revenue and cost of sales should represent **sales to, and purchases from, outsiders**. Sales revenue and cost of sales figures must be reduced by the value of intra-group sales during the year.
- › Any unrealised profits on intra-group trading should be excluded from the figure for group profits – they should be deducted from closing inventory in cost of sales.
- › **Dividends paid by the subsidiary to the parent** are cancelled on consolidation as dividend income is replaced with all income and expenses of the subsidiary.
- › Only the **post acquisition** profits of the subsidiary are brought into the consolidated statement of profit or loss. If the subsidiary has been acquired during the current financial year, then its results can only be included from the date of acquisition. Time apportion revenue and expenses.
- › The **non-controlling interest** is calculated at the end of the consolidation process. It represents the non-controlling interest's share of the subsidiary's profit after tax for the period.

CHAPTER 11

ACCOUNTING FOR ASSOCIATES



KEY LEARNING POINTS

- › Associates and significant influence were defined in Ch 8 (definitions revised on prior page).
- › Associates must be accounted for using the **equity method** unless the investment is classified as held for sale when it is accounted for under IFRS 5.
- › In the **consolidated statement of profit or loss** the parent company should record its **share of the profit after tax** of the associate.
- › In the **consolidated statement of financial position**, an investment in associates is recorded which is the total of:
 - Cost of investment
 - Group share of post-acquisition profits
 - Less impairment losses
- › An **associate is not consolidated** so none of the associate's income and expenses or assets and liabilities will be included within the group accounts. There is no non-controlling interest in an associate as it is not consolidated.
- › Intercompany transactions between the group and associate are not eliminated. The only exception to this is where there are **unrealised profits** and the **group share** is eliminated from the consolidated accounts.



TOPIC TIP

Associates are often examined as part of the group accounting question in Q1. Students need to know the method of accounting for associates.

Associates were tested in the June 2009, December 2009 and June 2010 exams.

CHAPTER 12

INVENTORIES AND CONSTRUCTION CONTRACTS



KEY LEARNING POINTS

- › Inventories are defined as **assets held for sale in the ordinary course of business** and can be raw materials, work in progress or finished goods.
- › They are recognised at the **lower of cost and net realisable value**.
- › The cost of inventories will **include all costs incurred** in bringing inventories to their **present location and condition** – includes original purchase cost and costs of conversion.
- › The selling price of inventory may fall below cost if the inventory is damaged or obsolete and should be written down to its net realisable value.



TOPIC TIP

The requirement to write down inventory to its net realisable value is sometimes seen in the published accounts questions (Q2).



KEY LEARNING POINTS

- › **IAS 11** defines a **construction contract** as a 'contract specifically negotiated for the construction of an asset or combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use'
- › **Contract revenue** will be the amount specified on the contract subject to any agreed variations.
- › **Contract costs** are those directly relating to the contract, any costs allocated to the contract, such as insurance or construction overheads and any other cost that can be charged to the customer.
- › Costs that **cannot be attributed** to the contract include general administration costs, selling costs, R&D and depreciation of assets not used on a specific contract.
- › Once the outcome of a contract can be estimated **reliably**, revenue and costs should be recognised according to the **stage of completion** of the contract.
- › The stage of completion can be measured by taking either the proportion of contract costs incurred for work carried out to date, surveys of work carried out or physical proportion of the contract work completed.
- › If the outcome of a contract **cannot be estimated reliably** then revenue can only be recognised to the extent of costs that have been incurred that are recoverable
- › Any **loss on a contract** should be recognised as soon as it is foreseen.



TOPIC TIP

Construction contracts can be examined in a stand-alone question or as part of a published financial statements question.

In June 2011 there was a 10-mark question on a construction contract.



KEY LEARNING POINT

- ▶ The **steps** to follow in accounting for a construction contract are:
 - Calculate the **estimated final profit** on the contract (if there is a loss it must be recognised immediately).
 - Work out the **percentage complete** using either the proportion of costs method or surveys of work performed method.
 - Calculate the revenue, cost of sales and profit to be **recognised** using the percentage complete calculated in (2).
 - Calculate the **gross amount due to / from customers** for the statement of financial position.



KEY LEARNING POINTS

- ▶ It is unlikely that students will be required to prepare detailed disclosures of a construction contract.
- ▶ Students should be aware of the type of information disclosed but should focus on the calculation of the figures to be recognised for contracts.

CHAPTER 13

PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS



KEY LEARNING POINTS

- A provision is a **liability of uncertain timing or amount** and therefore it is different from other types of liability such as trade payables.
- IAS 37 uses the definition of liability from the *Conceptual Framework* – a liability is a **present obligation** of the entity arising from **past events**, the settlement of which is expected to result in an **outflow** of resources embodying economic benefits
- An **obligation** can be:
 - **Legal:** it arises from the operation of the law
 - **Constructive:** it arises from the entity's pattern of past actions and there is a valid expectation that the entity will act in a certain way. For example, will clear up environmental damage when there is no legal obligation to do
- A **provision** is recognised when:
 - An entity has a **present obligation** as a result of a **past event**
 - **It is probable that an outflow of economic benefits is required**
 - **A reliable estimate can be made of the amount of obligation**
- A provision should be measured as the **best estimate** of the expenditure to settle the provision at the reporting date.
- If the time value of money is material the provision should be **discounted** to present value.
- Once recognised, a provision should **only** be used for the expenditure for which it was originally recognised.



TOPIC TIPS

- ▶ This is examined frequently and could form part of a published accounts preparation question (Q2) or a stand-alone question. It was question 4 in December 2008 and December 2011.
- ▶ Students will need to learn the definitions of a liability and provisions as well as the recognition rules and can expect to have to apply this to a scenario in the question.



KEY LEARNING POINTS

- ▶ If a provision does not need to be recognised, it may be that a contingent liability should be disclosed
- ▶ A **contingent liability** is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. For example, an outstanding legal case where the outcome is not yet certain
- ▶ A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. For example, an insurance claim that has not yet been settled by the insurance company



TOPIC TIP

If you can learn the flow chart you will be able to deal with most scenarios dealing with provisions and contingencies in the exam.

CHAPTER 1-

FINANCIAL ASSETS AND LIABILITIES



KEY LEARNING POINTS

- The definitions of financial instruments, financial assets, financial liabilities and equity instruments are given on the prior page
- Examples of **financial assets** include trade receivables, options and shares
- Examples of **financial liabilities** include trade payables, debenture loans payable and redeemable preference (non-equity) shares
- IAS 32 states that financial instruments should be presented according to their **substance, not merely their legal form**. Entities which issue financial instruments should classify them (or their component parts) as **either financial liabilities, or equity**
- A **liability** involves an **obligation** to transfer economic benefit so a financial liability is one where there is a **contractual obligation** on the issuer to deliver cash or another financial asset. Otherwise the financial instrument is an **equity instrument**
- **Redeemable preference shares** which are **redeemable** for a fixed amount at a fixed future date are treated as a financial liability as the issuer has an **obligation**
- Compound financial instruments contain **both a liability and an equity element**. IAS 32 requires the component parts of the instrument to be **classified separately**. One of the most common types of compound instrument is **convertible debt**
- IAS 32 requires the following method:
 - Calculate the value for the liability component by taking the present value of the cash flows of the debt
 - Deduct this from the proceeds of instrument to leave a residual value for the equity component
- Interest, dividends, losses and gains relating to a financial instrument classified as a **financial liability** should be recognised as **income or expense** in profit or loss
- Dividends on **equity instruments** should be recognised **directly in equity** by the issuer. These will appear in the statement of changes in equity



KEY LEARNING POINTS

- ▶ IFRS 9 applies to **all entities** and to **all types of financial instruments except** those specifically excluded, for example investments in subsidiaries, associates and joint ventures.
- ▶ A financial asset or financial liability should be recognised in the statement of financial position when the reporting entity becomes a party to the contractual provisions of the instrument.
- ▶ Financial instruments are initially measured at the **fair value** of the consideration given or received.
- ▶ After initial recognition financial assets are measured at either **fair value** or **amortised cost**.
- ▶ The exception to this is a financial asset held for trading which can be held at **fair value through profit or loss**.
- ▶ After initial recognition all **financial liabilities** should be measured at **amortised cost** or exceptionally **fair value through profit or loss**.
- ▶ For a financial asset held at **fair value** gains or losses will go through **other comprehensive income**.
- ▶ For financial assets or liabilities held at **fair value through profit or loss** gains or losses will go through profit or loss.



TOPIC TIP

The June 2008 paper had a 10-mark question on accounting for a financial instrument.
 The June 2009 paper had a financial instrument (redeemable preference shares) in Q2.
 The December 2011 paper had a 10-mark question on convertible loan notes.



KEY LEARNING POINTS

- › **Amortised cost of a financial asset or financial liability** is the amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation of any difference between that initial amount and the maturity amount, and minus any write-down for impairment or uncollectability
- › The **effective interest method** is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period
- › The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount
- › To account for a financial instrument at amortised cost means that it is recognised at the net proceeds and then interest is charged to profit or loss using the effective interest rate. The actual cash paid will be at the coupon rate of the debt. The end result is that by the end of the term of the debt, the liability is stated at its redemption amount



TOPIC TIP

Amortised cost has been examined frequently so students need to know how to apply the method to a particular financial instrument.



KEY LEARNING POINTS

- › Instruments designated as **fair value through profit or loss** have their gains and losses recognised **in profit or loss**
- › For financial instruments carried at **amortised cost**, their gains and losses are recognised **in profit or loss** as a result of the amortisation process and when the asset is derecognised (see prior page examples)
- › At the end of each reporting period, an entity should assess whether there is any objective evidence that a financial asset or group of assets is **impaired**
- › For assets held at amortised cost, the impairment loss is the **difference** between the asset's **carrying amount** and its **recoverable amount**. The asset's recoverable amount is the present value of estimated future cash flows, discounted at the financial instrument's **original** effective interest rate
- › The amount of the loss should be **recognised in profit or loss**



KEY LEARNING POINTS

- As well as specific monetary disclosures, **narrative commentary** by issuers is encouraged by the Standard. This will enable users to understand management's attitude to risk, whatever the current transactions involving financial instruments are at the period end.
- The examiner has indicated that he will not set questions about the **financial risks** of financial instruments.

CHAPTER 15

THE LEGAL VERSUS THE COMMERCIAL VIEW OF ACCOUNTING



KEY LEARNING POINTS

- ▶ **Off balance sheet transactions** are those which involve the removal of liabilities and in some circumstances, assets, from the financial statements
- ▶ It can also have an impact on **profit or loss** in that interest and depreciation are not charged if liabilities and assets have not been recognised
- ▶ Off balance sheet financing is a method of keeping **gearing** low
- ▶ If an off balance sheet transaction exists, it is difficult for users to have a clear view of the financial performance and position of an entity
- ▶ Hence, accounting standards require that the **substance of a transaction should be recorded** and not merely the legal form



TOPIC TIP

Off balance sheet financing has been examined in the past on both the published accounts questions (Q2) and as a stand-alone question (either Q4 or Q5).



KEY LEARNING POINTS

- ▶ The principle of substance over form is already enshrined in a number of accounting standards, eg IAS 17, IAS 11, IAS 24 and IFRS 3
- ▶ A particular application of substance over form relates to quasi-subidiaries. A **quasi-subidiary** is a company, trust, partnership or other vehicle that although not fulfilling the definition of a subsidiary is directly or indirectly controlled by the reporting entity and provides benefits no different from those that would arise if it were a subsidiary
- ▶ As IAS 27 defines a subsidiary based on the application of **control**, this curtailed the use of quasi-subidiaries so that structures set up with the specific objective of keeping liabilities off balance sheet would have to be consolidated
- ▶ An example of a quasi-subidiary transaction is if a company A sold its factory to an entity B which had been set up specifically for this transaction. Entity B is a subsidiary of a finance company and remits all profits and losses of the factory to the Company A less a management charge

This is not a genuine sale as Company A retains the benefits and risks relating to the factory – if it is profitable then Company A receives the profits and if it makes a loss, Company A is responsible for the loss. The substance of the transaction is actually a loan from the finance company secured on the factory. Company A should consolidate Entity B as it is indirectly under its control and both the factory asset and related finance should be recognised in the financial statements. Entity B is a quasi-subidiary



TOPIC TIP

Substance over form was examined in a 15-mark question in the June 2010 exam.



KEY LEARNING POINTS

- ▶ For the majority of transactions there will be **no difference** between economic substance and legal form
- ▶ If there is a difference between the two, then the **substance of the transaction** must be accounted for
- ▶ The key issue is whether a transaction has given rise to **new assets and liabilities** and whether it has changed any **existing assets and liabilities**
- ▶ There are usually factors that indicate that the substance of a transaction is different from its legal form. These include:
 - **The legal title to an item is separated** from the ability to enjoy the principal benefits and the exposure from the main risks
 - The **transaction is linked** to one or more other so that the commercial effect cannot be understood without reference to the complete series
 - The transaction includes **one or more options** under such terms that it makes it highly likely that the options will be exercised



KEY LEARNING POINTS

- ▶ **Consignment inventory** is an arrangement where inventory is held by one party but it is owned by another party. It is common in the motor trade where a manufacturer allows a dealer to display inventory on a sale or return basis
- ▶ The accounting issue is whether the entity holding the inventory has **genuinely purchased** the inventory or whether it is still an asset of the manufacturer
- ▶ The key to determining whether a purchase of inventory has taken place is to look at which party bears the **risks and rewards of ownership**. There are a number of factors to consider:

 - Which party is responsible for costs such as **maintenance and insurance** of the inventory (if it is the dealer then this suggests a purchase of the inventory)
 - Whether the dealer can **return the inventory** to the manufacturer without any penalty being payable (a right of return without penalty suggests that a purchase hasn't taken place)
 - Which party bears the **risk of obsolescence** of the inventory. If it is the dealer then this suggests a purchase of inventory has taken place
 - At what point in time the **price of the goods is determined**. If this is at delivery then it suggests that the dealer has purchased the goods
- ▶ If the inventory is deemed to be an asset of the dealer then it should be recognised in the dealer's statement of financial position. Any finance charge paid to the manufacturer should be recognised
- ▶ **Factoring of receivables / debt factoring** occurs when an entity sells its debts to the factor. The accounting issue is whether the debts have genuinely been sold to the factor or whether they have been used as a means of raising finance and the factor has provided a loan
- ▶ The factors that must be considered in establishing this are:

 - Which party is responsible for **irrecoverable debts**. If the customer hasn't paid after a certain period of time and the factor transfers the debt back to the seller, then it suggests that there has not been a genuine sale of the debts
 - The finance cost payable to the factor may depend on the **speed of collection** of debts. If this is the case then the seller has the responsibility for slow moving debts and therefore has not sold the assets to the factor
- ▶ If the seller of the debts retains the **risks and rewards of ownership** of the debts then they must continue to be shown in the financial statements. The amounts advanced from the factor will be shown as a liability and the related finance charge shown as an expense.



KEY LEARNING POINTS

- IAS 18 Revenue** covers revenue recognition arising from the sale of goods, rendering of services and interest, royalties and dividends
- Revenue is the **gross inflow of economic benefits** during the period arising in the course of the ordinary activities of an entity
- Revenue is measured at the **fair value of the consideration received**
- Revenue from the **sale of goods** should be recognised when **all** of the following conditions are satisfied:
 - The entity has transferred the significant risks and rewards of ownership of the goods to the buyer
 - The entity has no continuing managerial involvement in the goods sold
 - The amount of revenue can be measured reliably
 - It is probable that the economic benefits associated with the transaction will flow to the entity
 - The costs incurred in respect of the transaction can be measured reliably
- Revenue from the **rendering of services** can be recognised when the **all** of the following conditions are satisfied:
 - The amount of revenue can be measured reliably
 - It is probable that the economic benefits associated with the transaction will flow to the entity
 - The stage of completion of the transaction at the reporting date can be measured reliably
 - The costs incurred for the transaction and the costs to complete the transaction can be measured reliably
- If there is **uncertainty** about the outcome of a transaction involving the rendering of services then revenue is only recognised to the extent of the expenses recognised that are recoverable
- Interest** is recognised on a time proportion basis that takes in to account the effective yield on the assets
- Royalties** are recognised on an accruals basis in accordance with the substance of the relevant agreement
- Dividends** are recognised when the shareholders right to receive payment is recognised

CHAPTER 16

LEASING



KEY LEARNING POINTS

- ▶ In a leasing transaction there is a **contract** between the lessor and the lessee for the hire of an asset. The lessor retains legal ownership but conveys the right to use the asset to the lessee
- ▶ A **finance lease** is a lease that transfers **substantially all the risks and rewards** incident to ownership of an asset. A finance lease is presumed if at inception of the lease the **present value of the minimum lease payments** is approximately equal to the **fair value of the leased asset**. The present value is calculated using the **interest rate implicit in the lease**
- ▶ An **operating lease** is a lease other than a finance lease
- ▶ The **lease term** is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset



KEY LEARNING POINTS

- ▶ For an **operating lease** the lessee pays lease rentals which are charged as an expense to profit or loss
- ▶ For a **finance lease**, the substance of the transaction is that the lessee has acquired a non-current asset which is **capitalised** in the financial statements even if legal title is never acquired
- ▶ When an asset is acquired under a finance lease the **lower of the fair value of the asset and the present value of the minimum lease payments** is accounted for as follows:

DR Non-current assets	CR Finance lease liability
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- ▶ The asset should be depreciated over the shorter of the lease term and the asset's useful life unless the lessee expects to obtain ownership of the asset at the end of its useful life – in which case it is depreciated over its useful life
- ▶ Lease rental payments made will be a combination of interest on the finance provided by the lessor and a repayment of capital on the liability. The interest element of the lease payment is calculated using the actuarial method, where the finance charge is calculated based on the capital outstanding using the interest rate implicit in the lease



KEY LEARNING POINTS

- ▶ In the statement of financial position a number of lease disclosures are required
- ▶ For **finance leases**, the net carrying amount for each class of asset held under finance leases must be disclosed together with a reconciliation between the total of the minimum lease payments at the reporting date and their present value. Also the minimum lease payments and their present value should be disclosed for the following periods:
 - Within one year
 - Later than one year and no later than five years
 - Later than five years
- ▶ For **operating leases**, the total of future minimum lease payments under non-cancellable operating leases should be disclosed for the following periods:
 - Within one year
 - Later than one year and no later than five years
 - Later than five years



KEY LEARNING POINT

- ▶ Although not specifically required by IAS 17 *Leases*, most entities disclose the depreciation expense for assets held under finance leases and the finance cost for assets held under finance leases

CHAPTER 17

ACCOUNTING FOR TAXATION



KEY LEARNING POINTS

- ▶ The **double entry to record the tax expense** for the period is:
 - DR Tax expense
 - CR Tax payable
- ▶ Current tax relates to the tax payable on **profits** for the period
- ▶ If the estimated amount of **tax payable differs** from the amount actually paid there will be an **under-provision or over-provision of tax**. An under-provision means that the amount estimated was not sufficient and the shortfall must be **charged** in the following financial year. An over-provision means that too much was charged in the prior year and this amount is **credited** to the tax expense in the following year



TOPIC TIP

The calculation of the tax charge is a common feature of the published accounts question (Q2). It usually involves an over-or under-provision of tax and/or deferred tax.



KEY LEARNING POINTS

- ▶ If the accounting treatment of an item **differs** from its tax treatment then there are deferred tax implications.
- ▶ For example, if interest payable has not been paid and is accrued in the financial statements and that same interest is only deductible for tax when the cash is paid, then there is a difference between the accounting and the tax treatment. Deferred tax aims to provide for the differences.
- ▶ In establishing the differences between accounting and tax treatment of an item, IAS 12 compares the **carrying value of an asset** for accounts purposes and its **tax base**.
- ▶ The **tax base** is defined as the amount attributed to that asset or liability for tax purposes.
- ▶ The tax base is the amount that will be deductible for tax purposes against the taxable economic benefits the entity receives when it recovers the carrying value of the asset. Where the economic benefits are not taxable, the tax base of the asset is the same as its carrying value.



KEY LEARNING POINTS

- ▶ A **taxable temporary difference** is a difference that will result in taxable amounts in determining taxable profit / loss in future periods when the carrying amount of the asset or liability is recovered or settled, ie they are differences that cause tax to be paid in the future
- ▶ The following are examples of taxable temporary differences:
 - Tax depreciation of an asset is accelerated for tax purposes, ie more tax depreciation deducted than accounting depreciation
 - Development costs capitalised in the statement of financial position were deducted against taxable profit when the expenditure was incurred
 - Interest income is included in the statement of financial position when earned, but included in taxable profit when the cash is actually received
 - Prepayments in the statement of financial position that have been deducted against taxable profits when the cash expense was incurred
 - Revaluation of non-current assets with no adjustment of the tax base. This results in a larger difference between carrying value and tax base
- ▶ Deferred tax is provided on taxable temporary differences at the expected tax rate in force when the timing differences reverse, usually this is the current tax rate



TOPIC TIP

This is a very difficult concept for students to understand. They need to think of the effect of the transaction on accounting and taxable profits. This will not be examined in great depth in the exam, but students will need to understand the principles.



KEY LEARNING POINTS

- ▶ **Deductible temporary differences** are those which will result in amounts that are deductible in determining taxable profit/loss of future periods when the carrying amount of the asset or liability is recovered or settled, ie the expense is deductible for tax in future periods
- ▶ The following are examples of taxable temporary differences:
 - Accumulated **depreciation of an asset is greater than the tax depreciation** of the asset, ie less tax depreciation deducted than accounting depreciation
 - Income is **deferred** in the statement of financial position but has already been included in taxable profits in the current or prior periods
 - The net realisable value of inventory or a non-current assets has fallen and the **carrying value is reduced**, but the reduction is **ignored for tax purposes** until the asset is sold
- ▶ Deferred tax assets are only recognised to the extent it is **probable** that taxable profit will be available against which the asset can be utilised



KEY LEARNING POINTS

- ▶ The tax in the **statement of profit or loss** consists of the tax for the year, any under or overprovision from the prior year and the movement on the deferred tax provision. The movement on deferred tax will be a debit to profit or loss if the provision has increased and a credit if the provision has reduced
- ▶ The **statement of financial position** will include the current tax liability within current liabilities and the closing deferred tax provision in non-current liabilities



TOPIC TIP

This is the most common way tax is examined (Q2 – published accounts).

CHAPTER 18

EARNINGS PER SHARE



KEY LEARNING POINT

- ▶ The **basic calculation** is simply profit attributable to the ordinary shareholders divided by the number of ordinary shares in issue



TOPIC TIP

EPS is often examined as part of the published accounts question (Q2). In June 2011 it was examined for 6 marks as part of Q4.



KEY LEARNING POINTS

- ▶ If there has been a **bonus issue**, the bonus shares are treated as if they have always been in existence. This is because they have **no effect on the earnings** of the entity, they simply increase share capital. The **comparative EPS** for the prior year is also restated for the effect of the bonus issue
- ▶ The new share capital can be calculated using the **bonus fraction**: no of shares after the issue / no of shares before issue, ie in a 1 for 4 bonus issue the fraction would be 5/4
- ▶ If an issue of shares at **full market price** has been made, the **weighted average** number of shares must be calculated as the share issue brings cash into the business which is invested to earn more profit. The increase in earnings must be matched with the increase in shares and hence time apportioned to calculate the weighted average
- ▶ A **rights issue** is a new issue of shares to existing shareholders at a price that is **below the market value**. It combines an issue at full market price and a bonus issue of shares using the bonus element (on prior page). The calculation of the weighted average no of shares then treats the bonus element as if it had already been in existence and weights the average number of shares in issue in the same way as an issue at full market price



TOPIC TIP

Exam questions tend to ask for the trickier calculations, in particular, the rights issue which was last examined in December 2009.



KEY LEARNING POINTS

- › The diluted EPS aims to highlight to shareholders the **effect on current EPS** if all potential ordinary shares had been issued in the current period
- › Potential shares arise from **convertible debt** or **preference shares** that can be converted into ordinary shares in the future and **share options** that give the holder the right to subscribe for ordinary shares in the future
- › The earnings calculated for the basic EPS calculation should be **adjusted by the post-tax effect of interest or dividends** that would no longer be payable if the loan / shares were converted. There is no effect on earnings for share options as they only dilute EPS if the options are not exercisable at fair value
- › Where debt or preference shares can be converted at **various dates** in the future, always take the date that shows the **most dilution** of EPS – this will be the date with the most advantageous conversion rate
- › DEPS **does not predict** future EPS, rather it highlights the **potential effect on EPS** if all potential shares were issued now



TOPIC TIP

In the past exam questions have asked for a discussion on why DEPS is disclosed together with the calculation of the DEPS.

CHAPTER 19

ANALYSING AND INTERPRETING FINANCIAL STATEMENTS



KEY LEARNING POINTS

-  **ROCE** is a key measure of performance. It shows how well the entity is using the capital employed in the business to generate profits. It is calculated using capital employed which is usually **total assets less current liabilities**
-  It can be difficult to compare ROCE between different entities if they have different **capital structures**. Manufacturing businesses tend to have high levels of assets and would have a lower ROCE than a service company with fewer assets and therefore a higher ROCE
-  Certain **accounting policy decisions** can affect ROCE such as the revaluation of assets. This will increase capital employed and therefore profit becomes a lower percentage of capital employed
-  **Gross margin** is another key indicator as it shows the results of the business's operating activities. Gross margin may increase if sales prices have been increased or the sales mix has changed and more profitable goods are being sold. It may decrease if raw material costs increase and increases cannot be passed onto customers. It may also be a deliberate management policy if prices are cut to attract new customers
-  **Asset turnover** shows how much sales revenue has been generated from the capital employed in the business. It is a measure of the **efficiency** of the business and the greater the asset turnover the better use being made of capital employed to generate revenue
-  There is a link between **net profit margin and asset turnover** as the two ratios can explain the movement in ROCE. If ROCE has changed, students should then calculate asset turnover and net profit margin to see if the reason for the change in ROCE is **increased profits or increased efficiency**



TOPIC TIP

This is a highly examinable area and students must memorise the key accounting ratios. It is examined in almost every paper, sometimes combined with a statement of cash flows.



KEY LEARNING POINTS

- ▶ **Liquidity** is the amount of cash a company can put its hands on quickly to settle its debts. It consists of **cash, short-term investments, fixed-term deposits and trade receivables**, ie assets that can be quickly converted into cash
- ▶ The **cash cycle** shows the flow of cash out of business and back into it again as a result of trading operations
- ▶ The **current ratio** measures whether an entity can meet its current liabilities from its current assets. A ratio in excess of 1 is expected but the result will vary depending on the type of business. Retailers will not have receivables balances as they tend to be cash businesses, so their current ratio will be low which will not be seen to be a problem
- ▶ The **quick ratio** is an adaptation of the current ratio. Inventories are removed from current assets so the ratio is lower than the current ratio
- ▶ **Trade receivables collection period** measures the amount of time it takes for a business to collect cash from customers. Generally, the shorter the period the better as it means that cash is collected quickly. However, in some businesses longer credit terms are given to encourage sales. Generally, sales are made on terms of 30 days' credit
- ▶ **Inventory turnover** measures the amount of time inventories are held in the business. The longer inventories are held, the longer cash is tied up in the business. Inventory turnover will vary among different types of businesses. Typically retailers will have much faster inventory turnover than manufacturing companies
- ▶ **Accounts payable payment period** measures the amount of time it takes for a business to pay its suppliers. If long credit terms are taken then this is positive for cash flow. However, if too long is taken, suppliers may refuse to supply on credit



KEY LEARNING POINTS

- ▶ If a company has **large amounts of debt**, banks and other lenders will be **less willing** to advance further funds
- ▶ If profits are low and a company is highly geared, there will be very little profit left over for shareholders once the interest charges have been paid. If profits fall or interest rates rise, the company could potentially face liquidation as the **interest charge may be in excess of profit before interest and tax**
- ▶ The **gearing ratio** measures the proportion of debt to capital employed. There is no absolute limit on what the ratio should be, more than 50% is said to be high gearing
- ▶ Any factor that affects **capital employed** will affect the gearing ratio. If a company **revalues its assets** during the year, the gearing ratio will reduce as debt will become a lower proportion of an increased capital employed figure
- ▶ The **debt / equity** ratio shows the proportion of debt to shareholders' funds. A level of 100% or more is high, meaning that debt is equal to equity
- ▶ **Interest cover** shows whether a company is earning enough profit before interest and tax to cover the interest cost comfortably. If interest cover is low, it means that interest costs are a high proportion of profits and there is the risk that if profits fall, the interest charge cannot be covered



TOPIC TIP

Students should look for actions a company has taken to improve its gearing position. This might include revaluations to present the ratio in a more favourable light and off balance sheet financing to remove debt and assets from the statement of financial position.



KEY LEARNING POINTS

- ▶ **Dividend yield** shows the return a shareholder is expecting on the shares of a company. Shareholders are interested in dividends income and capital growth in their investments
- ▶ **Dividend cover** shows the proportion of profit that is available for distribution to shareholders. A high dividend cover means that a higher level of profits are retained in the business
- ▶ The **price/earnings ratio** compares current share price to the earnings per share figure. A high P/E ratio indicates strong **shareholder confidence** in the company and its future. It is a commonly quoted stock exchange performance indicator
- ▶ **Earnings yield** is the inversion of the P/E ratio and measures the earnings as a percentage of market price of a share. It is less widely used than the P/E ratio

CHAPTER 20

LIMITATIONS OF FINANCIAL STATEMENTS AND INTERPRETATION TECHNIQUES



KEY LEARNING POINTS

-  **Historical cost** information is useful in that it can be verified, but over time the information becomes less relevant as values for assets become **out of date**. The corresponding depreciation is lower than it would be if the assets were carried at valuation and therefore profit can be overstated.
-  **Creative accounting techniques** may be used to present financial information in the most favourable light. This may include manipulating figures to show steady performance increases or favourable cash positions at the reporting date. In particular, companies may wish to show the gearing ratio as low as possible and so may enter into '**off balance sheet**' transactions with the aim of removing assets and liabilities from the statement of financial position.
-  **Related party transactions** can have a significant effect on individual entity financial statements, particularly if that entity is the **member of a group** of companies. An entity may have to sell goods to a parent or fellow subsidiary at a lower cost than on an arms' length basis, or a subsidiary may be able to borrow finance at rates that are different to the market rate.
-  Companies who have trade that is **seasonal** tend to have their financial year end after the busy period. The statement of financial position at that point in time may not show the typical position for the entity.
-  If **assets are purchased prior to the year end** the statement of financial position shows the assets and related finance, but the income that will be earned from the assets has yet to filter into the accounts. This has the effect of reducing the ROCE ratio.



TOPIC TIP

In the exam most of the marks are given for good interpretation of the financial statements and the ratios that have been calculated. The factors above need to be given careful consideration.



KEY LEARNING POINTS

- There are certain **choices within accounting standards** which can affect the position shown in the financial statements. The most common example is the decision whether to revalue non-current assets or keep them at historical cost.
- An accounting policy can only be changed if there is a **change in an accounting standard** or the new policy gives a **fairer presentation** of the financial performance and position of the entity. Accounting policies cannot be changed to show increased profits.
- Ratios are influenced by **choices in accounting policies** so if a company that revalues non-current assets is compared with one that does not, the ratios will not be comparable. Revaluing non-current assets increased the assets in the business and therefore affects capital employed, and also increases the depreciation charge which reduces profit.

CHAPTER 21

STATEMENT OF CASH FLOWS



KEY LEARNING POINTS

- › The format of the statement of cash flows is very straightforward with cash flows being divided into **three categories** – **operating, investing** and **financing**
- › The statement of cash flows is **totalled** to the **movement in cash and cash equivalents**. Cash is cash on hand and demand deposits. Cash equivalents are short-term highly liquid investments that are readily convertible to known amounts of cash



TOPIC TIP

The statement of cash flows will be examined as Q3 of the exam and features in most sittings. It may be examined with interpretation of financial statements. Q3 in the June 2009 paper is a good example.



KEY LEARNING POINTS

- › The **indirect method** takes the profit after tax for the period and adjusts it for non cash items such as depreciation, amortisation and provisions as well as the movements on working capital
- › The **direct method** takes gross cash flows from the accounting records such as the amount of cash paid to suppliers, employees and the cash received from customers. To calculate these figures in an exam, students would need to set up a T-account and calculate the cash flow as the balancing figure



TOPIC TIP

The examiner usually asks for the indirect method as it uses the information straight from the financial statements but students must also be aware of the direct method.



KEY LEARNING POINTS

- ▶ **Purchase or disposal of non-current assets** – there will be a great deal of information given about non-current assets and students need to work out what is missing. Watch out for balances such as revaluations or purchase of assets under finance leases which are non cash, **only cash purchases should be included** in the statement of cash flows
- ▶ The **tax paid** can be complicated as the working will need to include all tax balances in the financial statements which includes the **deferred tax** provision. This is because the movement on deferred tax is part of the profit or loss tax charge so to calculate the correct tax paid, both current and deferred tax should be included in the working
- ▶ When an asset is acquired under a **finance lease** it is a **non cash transaction** (DR Assets CR Lease) so the cash flow only needs to show the lease payments made in the period. This is calculated by reconciling the lease creditor – this is split into current and non-current so don't forget to include all balances relating to the lease



TOPIC TIP

- ▶ Typically in an exam question, the tricky areas that require workings are non-current assets, finance leases, tax, government grants and share capital. T-accounts are very useful.
- ▶ The examiner provides enough information to do a reconciliation of the item, bringing in all relevant balances so that when the account is balanced the missing figure is the cash paid or received.
- ▶ Students should practice plenty of questions to get the hang of this technique.



KEY LEARNING POINTS

- ▶ The relationship between cash and profits is an important one. An ideal situation is that **operating cash flows exceed operating profit** which indicates that all of an entity's profit is converted into cash. However, this won't be the case all of the time as cash flows are not smoothed out by accruals, prepayments, provisions etc in the same way that profits are.
- ▶ If interpreting a statement of cash flows, look at where the **key inflows and outflows** are occurring, with particular reference to investment in new assets, repayment or issuing of debt or equity finance, and dividend payments.
- ▶ Some **advantages of cash flow reporting** include:
 - Survival in business depends on the ability to generate cash
 - Cash is not dependent on accounting conventions such as accruals
 - Cash flow reporting can be a better method of comparing results with other entities
 - Cash flow reporting satisfies the needs of users, such as creditors and lenders



TOPIC TIP

Interpretation of a statement of cash flows can be asked for as a secondary part of a cash flow preparation question (Q3).

CHAPTER 22

ALTERNATIVE MODELS AND PRACTICES



KEY LEARNING POINTS

- › Under **financial capital maintenance**, profit is the increase in monetary capital over the period. This is used in **historical cost accounting**.
- › Under **physical capital maintenance**, profit is the increase in physical productive capital over the period. This is used in **current cost accounting**.
- › **Profit** can be measured as the difference in capital between the beginning and end of an accounting period. In times of rising prices, there can be difficulties in this profit measurement as the entity may have identical physical assets at the beginning and end of the period but as the cost is greater at the end of the period, a profit is recorded which is no more than the company keeping pace with inflation.



TOPIC TIP

This topic is very rarely examined. Students should have an outline knowledge of the principles.



KEY LEARNING POINTS

- › In times of rising prices it is incorrect to assume that \$1 at the beginning of the year has the same value as \$1 at the end of the year
- › There are **two types of price inflation** – specific price inflation which measures price changes over time for a specific asset or group of assets and general price inflation which is the average rate of inflation and reduces the general purchasing power of money
- › **Current purchasing power** measures profits as the increase in the current purchasing power of equity. Profits are stated after allowing for inflation. Monetary items are not restated as their amounts are fixed but non-monetary items are restated in line with the general price index
- › **Current cost accounting** approaches capital maintenance by maintaining the operating capability of the business. The value of assets in the statement of financial position and consumed during the year should be stated at their value to the business (deprival value)
- › Capital maintenance is measured by the ability of the entity to keep to the **same level of operating capability**
- › **Deprival value** can be replacement cost, net realisable value or economic value / value in use

CHAPTER 23

NOT-FOR-PROFIT AND PUBLIC SECTOR ENTITIES



KEY LEARNING POINTS

- ▶ Not-for-profit and public sector entities include government agencies, healthcare agencies, schools, colleges and charities
- ▶ Even though not-for-profit entities **do not report to shareholders**, they must be able to account for the funds received and the way they have been allocated
- ▶ Their objective is to provide goods and services to various recipients and not make a profit
- ▶ A **public sector entity** such as local government will have the aim of providing services to its local community such as fire services, refuse collection, libraries, theatres and sports facilities
- ▶ A **charity** will have the aim of providing assistance to a particular cause, for example poverty aid in developing countries, child protection, animal rescue



TOPIC TIP

If this topic is examined it is likely to be in overview only. One possible option is to ask how an accounting transaction affects a public sector entity. Students need to remember that the focus of these entities is not to make a profit but to achieve a stated aim.



KEY LEARNING POINTS

- › There is an aim overall for not-for-profit entities to produce accounts which are based as far as possible on the provisions of IFRSs
- › One of the issues being debated in regard to these entities is the **definition of a liability**. The *Conceptual Framework* describes a liability as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. Public services have a commitment to provide public services, but that commitment may not meet the definition of a liability as the entity has received no goods and services for which it is required to settle
- › In the UK, charities are regulated by a **Statement of Recommended Practice** which was updated in 2005. SORP 2005 is a summary of how accounting standards, charity law and company law impact on charity financial reporting



KEY LEARNING POINTS

- › The performance of a public sector or not-for-profit entity will be in terms of measuring whether its **stated aims have been achieved**
- › One measure of performance for public sector entities is the 3 Es – **economy, efficiency and effectiveness**
- › Another performance consideration is whether the entity has achieved **value for money**, particularly in respect of obtaining outside contractors for certain functions, eg contracting out cleaning in a hospital
- › Charities must focus on demonstrating that they have made **proper use** of the funds received and whether they have achieved their stated aims. A charity might produce an **impact report** which shows what they have achieved and what they still aim to achieve and will have its own performance indicators to measure this



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FOR EXAMS UP TO JUNE
2014

ISBN 978-1-4453-5251-0



F7 .Revision .Notes .2014

