

ACCA

SBR

Strategic Business
Reporting

Study Text

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LINGUISTIC DIVERSITY, EQUALITY AND INCLUSION

We are committed to diversity, equality and inclusion and strive to deliver content that all users can relate to.

We are here to make a difference to the success of every learner.

Clarity, accessibility and ease of use for our learners are key to our approach.

We will use contemporary examples that are rich, engaging and representative of a diverse workplace.

We will include a representative mix of race and gender at the various levels of seniority within the businesses in our examples to support all our learners in aspiring to achieve their potential within their chosen careers.

Roles played by characters in our examples will demonstrate richness and diversity by the use of different names, backgrounds, ethnicity and gender, with a mix of sexuality, relationships and beliefs where these are relevant to the syllabus.

It must always be obvious who is being referred to in each stage of any example so that we do not detract from clarity and ease of use for each of our learners.

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We will seek to devise simple measures that can be used by independent assessors to randomly check our success in the implementation of our Linguistic Equality, Diversity and Inclusion Policy.

British Library Cataloguing-in-Publication Data

A catalogue record for this book is available from the British Library.

Published by:

Kaplan Publishing UK
Unit 2 The Business Centre
Molly Millar's Lane
Wokingham
Berkshire
RG41 2QZ

ISBN: 978-1-83996-123-6

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Acknowledgements

These materials are reviewed by the ACCA examining team. The objective of the review is to ensure that the material properly covers the syllabus and study guide outcomes, used by the examining team in setting the exams, in the appropriate breadth and depth. The review does not ensure that every eventuality, combination or application of examinable topics is addressed by the ACCA Approved Content. Nor does the review comprise a detailed technical check of the content as the Approved Content Provider has its own quality assurance processes in place in this respect.

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Introduction

This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2022 IFRS Standards Red Book.

How to use the Materials

Strategic Business Reporting is an exam at the Strategic Professional level of the ACCA qualification. It assumes knowledge acquired at the Fundamentals level including the core technical capabilities to prepare and analyse financial reports for single and combined entities

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your examinations.

The product range contains a number of features to help you in the study process. They include:

- 1 Detailed study guide and syllabus objectives
- 2 Description of the examination
- 3 Study skills and revision guidance
- 4 Study text
- 5 Question practice

The sections on the study guide, the syllabus objectives, the examination and study skills should all be read before you commence your studies. They are designed to familiarise you with the nature and content of the examination and give you tips on how to best to approach your learning.

The **Study Text** comprises the main learning materials and gives guidance as to the importance of topics and where other related resources can be found. Each chapter includes:

- The **learning objectives** contained in each chapter, which have been carefully mapped to the examining body's own syllabus learning objectives or outcomes. You should use these to check you have a clear understanding of all the topics on which you might be assessed in the examination.
- The **chapter diagram** provides a visual reference for the content in the chapter, giving an overview of the topics and how they link together.
- The **content** for each topic area commences with a brief explanation or definition to put the topic into context before covering the topic in detail. You should follow your studying of the content with a review of the illustration/s. These are worked examples which will help you to understand better how to apply the content for the topic.

- **Test your understanding** sections provide an opportunity to assess your understanding of the key topics by applying what you have learned to short questions. Answers can be found at the back of each chapter.
- **Summary diagrams** complete each chapter to show the important links between topics and the overall content of the paper. These diagrams should be used to check that you have covered and understood the core topics before moving on.
- **Question practice** is provided through this text.

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details, or follow the link to the feedback form in MyKaplan.

Our Quality Coordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon Explanations



Definition – Key definitions that you will need to learn from the core content.



Key point – Identifies topics that are key to success and are often examined.



Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an exam question. **Reference to this text is vital when self studying.**



Test your understanding – Exercises for you to complete to ensure that you have understood the topics just learned.



Illustration – Worked examples help you understand the core content better.



Tutorial note – Included to explain some of the technical points in more detail.



Footsteps – Helpful tutor tips.



Links to other syllabus areas – This symbol refers to areas of interaction with other parts of your syllabus, either in terms of other ACCA papers that you have studied, or may go on to study, or even further professional qualifications that you may decide to pursue on completion of ACCA.

On-line subscribers

Our on-line resources are designed to increase the flexibility of your learning materials and provide you with immediate feedback on how your studies are progressing.

If you are subscribed to our on-line resources you will find:

- 1 On-line referenceware: reproduces your Study Text on-line, giving you anytime, anywhere access.
- 2 On-line testing: provides you with additional on-line objective testing so you can practice what you have learned further.
- 3 On-line performance management: immediate access to your on-line testing results. Review your performance by key topics and chart your achievement through the course relative to your peer group.

Ask your local customer services staff if you are not already a subscriber and wish to join.

Paper introduction

Paper background

The Strategic Business Reporting (SBR) syllabus requires learners to examine corporate reporting from the perspective of a variety of different stakeholders. The syllabus requires the assessment and evaluation of the reporting decisions made by management and their implications for a range of stakeholders and entities. It also explores the professional and ethical responsibilities of the accountant to these stakeholders.

Objectives of the syllabus

Candidates should be able to:

- Apply fundamental ethical and professional principles to ethical dilemmas and discuss the consequences of unethical behaviour
- Evaluate the appropriateness of the financial reporting framework and critically discuss changes in accounting regulation
- Apply professional judgement in the reporting of the financial performance of a range of entities
- Prepare the financial statements of groups of entities
- Interpret financial statements for different stakeholders
- Communicate the impact of changes and potential changes in accounting regulation on financial reporting
- Demonstrate employability and technology skills.

Syllabus

Core areas of the syllabus

- Fundamental ethical and professional principles
- The financial reporting framework
- Reporting the financial performance of a range of entities
- Financial statements of groups of entities
- Interpret financial statements for different stakeholders
- The impact of changes and potential changes in accounting regulation.

Approach to INT and UK syllabus elements

The international syllabus has been used as the basis of this Study Text. The additional content required for those sitting the UK paper is in Chapter 24.

The UK exam primarily tests International Financial Reporting Standards. The Examiner has indicated that part of one of the Section B questions in the UK paper will be adapted to assess UK specific content. This question may be based on either a single entity or a group and will be worth approximately 15-20 marks. It may have discursive and/or numerical content and requirements, and could cover the following syllabus areas:

- The financial reporting requirements for UK and Republic of Ireland entities (UK GAAP) and their interaction with the Companies Act requirements
- The reasons why an entity might choose to adopt FRS 101 or FRS 102
- The scope and basis of preparation of financial statements under UK GAAP
- The concepts and pervasive principles set out in FRS 102
- The principal differences between UK GAAP and International Financial Reporting Standards.

ACCA Performance Objectives

In order to become a member of the ACCA, as a trainee accountant you will need to demonstrate that you have achieved nine performance objectives. Performance objectives are indicators of effective performance and set the minimum standard of work that trainees are expected to achieve and demonstrate in the workplace. They are divided into key areas of knowledge which are closely linked to the exam syllabus.

There are five Essential performance objectives and a choice of fifteen Technical performance objectives which are divided into five areas.

The performance objectives which link to this exam are:

- 1 Ethics and professionalism (Essential)
- 2 Stakeholder relationship management (Essential)
- 3 Record and process transactions and events (Technical)
- 4 Prepare external financial reports (Technical)
- 5 Analyse and interpret financial reports (Technical)

The following link provides an in depth insight into all of the performance objectives:

https://www.accaglobal.com/content/dam/ACCA_Global/Students/per/PER-Performance-objectives-achieve.pdf

Progression

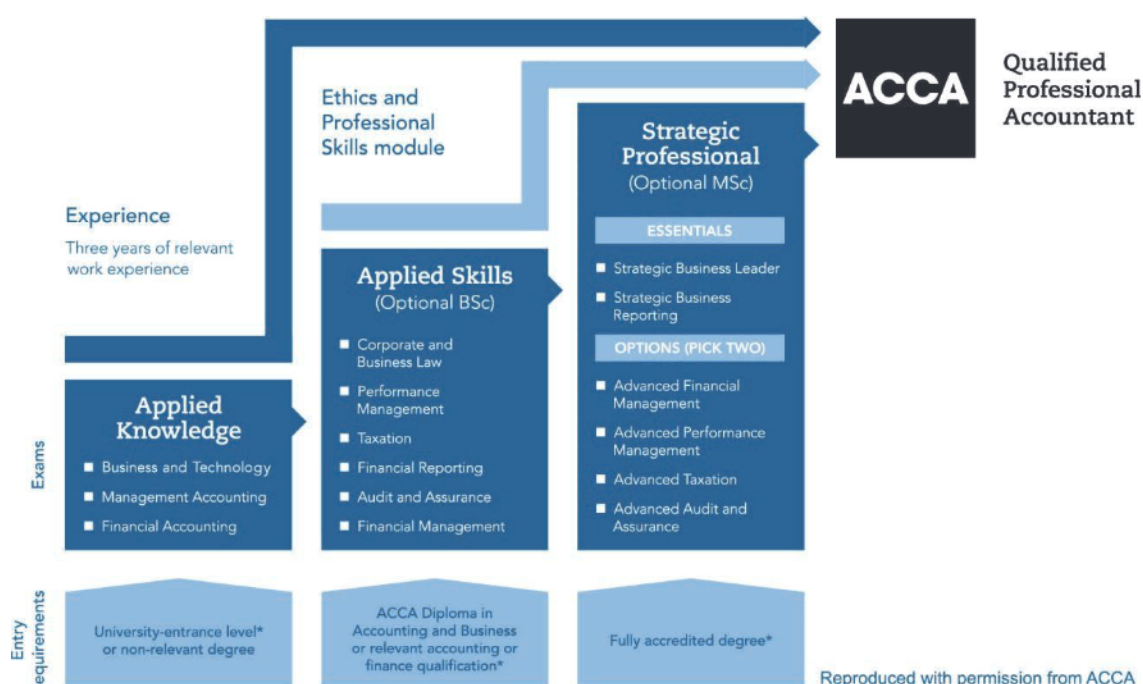
There are two elements of progression that we can measure: first how quickly learners move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from learner to learner. However, using data and our experience of learner performance over many years, we can make some generalisations.

A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.



Syllabus objectives

We have reproduced the ACCA's syllabus below:

A FUNDAMENTAL ETHICAL AND PROFESSIONAL PRINCIPLES

1 Professional and ethical behaviour in corporate reporting

- (a) Appraise and discuss the importance of ethical and professional behaviour in complying with accounting standards and corporate reporting requirements.^[3]
- (b) Assess and discuss the consequences of unethical behaviour by management in carrying out their responsibility for the preparation of corporate reports.^[3]

B THE FINANCIAL REPORTING FRAMEWORK

1 The applications, strengths and weaknesses of an accounting framework

- (a) Discuss the importance of the *Conceptual Framework for Financial Reporting* in underpinning the production of accounting standards.^[3]
- (b) Discuss the objectives of financial reporting including disclosure of information that can be used to help assess management's stewardship of the entity's resources, and the limitations of financial reporting.^[3]
- (c) Discuss the nature of the qualitative characteristics of useful financial information.^[3]
- (d) Explain the roles of prudence and substance over form in financial reporting.^[3]
- (e) Discuss the high level measurement uncertainty that can make financial information less relevant.^[3]
- (f) Evaluate the decisions made by management on recognition, derecognition and measurement.^[3]
- (g) Critically discuss and apply the definitions of the elements of financial statements and the reporting of items in the statement of profit or loss and other comprehensive income.^[3]

C REPORTING THE FINANCIAL PERFORMANCE OF A RANGE OF ENTITIES

1 Revenue

- (a) Discuss and apply the criteria that must be met before an entity can recognise revenue.^[3]
- (b) Discuss and apply the accounting requirements relating to revenue earned from a contract with a customer.^[3]
- (c) Apply the criteria for recognition of contract costs as an asset.^[3]
- (d) Discuss and apply the recognition and measurement of revenue including performance obligations satisfied over time, sale with a right of return, consignment arrangements, warranties, variable consideration, principal versus agent considerations and non-refundable up-front fees.^[3]

2 Non-current assets

- (a) Discuss and apply the recognition, derecognition and measurement of non-current assets including impairments and revaluations.^[3]
- (b) Discuss and apply the accounting requirements for the classification and measurement of non-current assets held for sale.^[3]
- (c) Discuss and apply the accounting treatment of investment properties including classification, recognition, measurement and change of use.^[3]
- (d) Discuss and apply the accounting treatment of intangible assets including the criteria for recognition and measurement subsequent to acquisition.^[3]
- (e) Discuss and apply the accounting treatment for borrowing costs.^[2]

3 Financial instruments

- (a) Discuss and apply the initial recognition and measurement of financial instruments.^[3]
- (b) Discuss and apply the subsequent measurement of financial assets and financial liabilities.^[3]
- (c) Discuss and apply the derecognition of financial assets and financial liabilities.^[2]
- (d) Discuss and apply the reclassification of financial assets.^[2]
- (e) Account for derivative financial instruments, and simple embedded derivatives.^[2]
- (f) Outline and apply the qualifying criteria for hedge accounting and account for fair value hedges and cash flow hedges including hedge effectiveness.^[2]
- (g) Discuss and apply the general approach to impairment of financial instruments including the basis for estimating expected credit losses.^[2]
- (h) Discuss the implications of a significant increase in credit risk.^[2]
- (i) Discuss and apply the treatment of purchased or originated credit impaired financial assets.^[2]

4 Leases

- (a) Discuss and apply the lessee accounting requirements for leases including the identification of a lease and the measurement of the right of use asset and liability.^[3]
- (b) Discuss and apply the accounting for leases by lessors.^[3]
- (c) Discuss and apply the circumstances where there may be re-measurement of the lease liability.^[3]
- (d) Discuss and apply the reasons behind the separation of the components of a lease contract into lease and non-lease elements.^[3]
- (e) Discuss the recognition exemptions under the current leasing standard.^[3]
- (f) Discuss and apply the principles behind accounting for sale and leaseback transactions.^[3]

5 Employee benefits

- (a) Discuss and apply the accounting treatment of short term and long term employee benefits, termination benefits, and defined contribution and defined benefit plans.^[3]
- (b) Account for gains and losses on settlements and curtailments.^[2]
- (c) Account for the 'Asset Ceiling' test and the reporting of actuarial gains and losses.^[2]

6 Income taxes

- (a) Discuss and apply the recognition and measurement of deferred tax liabilities and deferred tax assets.^[3]
- (b) Discuss and apply the recognition of current and deferred tax as income or expense.^[3]
- (c) Discuss and apply the treatment of deferred taxation on a business combination.^[2]

7 Provisions, contingencies, events after the reporting date

- (a) Discuss and apply the recognition, de-recognition and measurement of provisions, contingent liabilities and contingent assets including onerous contracts, environmental provisions and restructuring provisions.^[3]
- (b) Discuss and apply the accounting for events after the reporting period.^[3]

8 Share-based payment

- (a) Discuss and apply the recognition and measurement of share-based payment transactions.^[3]
- (b) Account for modifications, cancellations and settlements of share-based payment transactions.^[2]

9 Fair value measurement

- (a) Discuss and apply the definitions of 'fair value' measurement and 'active market'.^[3]
- (b) Discuss and apply the 'fair value hierarchy'.^[3]
- (c) Discuss and apply the principles of highest and best use, most advantageous and principal market.^[3]
- (d) Explain the circumstances where an entity may use a valuation technique.^[3]

10 Reporting requirements of small and medium-sized entities (SMEs)

- (a) Discuss the key differences in accounting treatment between full IFRS Standards and the IFRS for SMEs Standard.^[3]
- (b) Discuss and apply the simplifications introduced by the IFRS for SMEs Standard.^[3]

11 Other reporting issues

- (a) Discuss and apply the accounting for, and disclosure of, government grants and other forms of government assistance.^[2]
- (b) Outline the principles behind the application of accounting policies and measurement in interim reports.^[2]
- (c) Discuss and apply the judgements required in selecting and applying accounting policies, accounting for changes in estimates and reflecting corrections of prior period errors.^[3]
- (d) Identify related parties and assess the implications of related party relationships in the preparation of corporate reports.^[3]

D FINANCIAL STATEMENTS OF GROUPS OF ENTITIES

1 Group accounting including statements of cash flow

- (a) Discuss and apply the principles behind determining whether a business combination has occurred.^[2]
- (b) Discuss and apply the method of accounting for a business combination including identifying an acquirer and the principles in determining the cost of a business combination.^[2]
- (c) Apply the recognition and measurement criteria for identifiable acquired assets and liabilities including contingent amounts and intangible assets.^[3]
- (d) Discuss and apply the accounting for goodwill and non-controlling interest.^[3]
- (e) Apply the accounting principles relating to a business combination achieved in stages.^[3]
- (f) Discuss and apply the application of the control principle.^[2]
- (g) Determine and apply appropriate procedures to be used in preparing consolidated financial statements.^[3]

- (h) Discuss and apply the implications of changes in ownership interest and loss of control or significant influence.^[3]
- (i) Prepare group financial statements where activities have been discontinued, or have been acquired or disposed of in the period.^[3]
- (j) Discuss and apply the treatment of a subsidiary which has been acquired exclusively with a view to subsequent disposal.^[2]
- (k) Identify and outline the circumstances in which a group is required to prepare consolidated financial statements; the circumstances when a group may claim an exemption from the preparation of consolidated financial statements, and why directors may not wish to consolidate a subsidiary and where this is permitted.^[2]
- (l) Prepare and discuss group statements of cash flows.^[3]

2 Associates and joint arrangement

- (a) Identify associate entities.^[3]
- (b) Discuss and apply the equity method of accounting for associates.^[3]
- (c) Discuss and apply the application of the joint control principle.
- (d) Discuss and apply the classification of joint arrangements.^[3]
- (e) Prepare the financial statements of parties to the joint arrangement.^[3]

3 Changes in group structures

- (a) Discuss and apply accounting for group companies in the separate financial statements of the parent company.^[2]
- (b) Apply the accounting principles where the parent reorganises the structure of the group by establishing a new entity or changing the parent.^[2]

4 Foreign transactions and entities

- (a) Outline and apply the translation of foreign currency amounts and transactions into the functional currency and the presentational currency.^[3]
- (b) Account for the consolidation of foreign operations, including subsidiaries, associates and joint arrangements, and their disposal.^[3]

E INTERPRET FINANCIAL STATEMENTS FOR DIFFERENT STAKEHOLDERS

1 Analysis and interpretation of financial information and measurement of performance

- (a) Discuss and apply relevant indicators of financial and non-financial performance including earnings per share and additional performance measures.^[3]
- (b) Discuss the increased demand for transparency in corporate reports, and the emergence of non-financial reporting standards.^[3]

- (c) Appraise the impact of environmental, social, and ethical factors on additional performance measures.^[3]
- (d) Discuss the importance of effective sustainability reporting.^[3]
- (e) Discuss how integrated reporting improves the understanding of the relationship between financial and non-financial performance and of how a company creates sustainable value.^[3]
- (f) Determine the nature and extent of reportable segments.^[3]
- (g) Discuss the nature of segment information to be disclosed and how segmental information enhances the quality and sustainability of performance.^[3]

F THE IMPACT OF CHANGES AND POTENTIAL CHANGES IN ACCOUNTING REGULATION

1 Discussion of solutions to current issues in financial reporting

- (a) Discuss and apply the accounting implications of the first time adoption of new accounting standards.^[2]
- (b) Identify issues and deficiencies which have led to proposed changes to an accounting standard.^[3]
- (c) Discuss the impact of current issues in corporate reporting. This learning outcome may be tested by requiring the application of one or several existing standards to an accounting issue. It is also likely to require an explanation of the resulting reporting and disclosure implications from events such as:
 - accounting for digital assets
 - accounting for the effects of a natural disaster
 - climate change
 - a global event
 - going concern assessments.
- (d) The following examples are relevant to the current syllabus:^[3]
 - Materiality in the context of financial reporting
 - Management commentary
- (e) Discuss developments in devising a structure for corporate reporting that addresses the needs of stakeholders.^[3]
- (f) Discuss developments in corporate reporting related to sustainability reporting and sustainability standards.^[3]

G EMPLOYABILITY AND TECHNOLOGY SKILLS

- 1 Use computer technology to efficiently access and manipulate relevant information.**
- 2 Work on relevant response options, using available functions and technology, as would be required in the workplace.**
- 3 Navigate windows and computer screens to create and amend responses to exam requirements using the appropriate tools.**
- 4 Present data and information effectively, using the appropriate tools.**

The superscript numbers in square brackets indicate the intellectual depth at which the subject area could be assessed within the examination. Level 1 (knowledge and comprehension) broadly equates with the Knowledge module, Level 2 (application and analysis) with the Skills module and Level 3 (synthesis and evaluation) to the Professional level. However, lower level skills can continue to be assessed as you progress through each module and level.

The examination

Examination format

The syllabus is assessed by a three-hour fifteen minute examination. It examines professional competences within the business reporting environment.

Learners will be examined on concepts, theories, and principles, and on their ability to question and comment on proposed accounting treatments.

Learners should be capable of relating professional issues to relevant concepts and practical situations. The evaluation of alternative accounting practices and the identification and prioritisation of issues will be a key element of the exam. Professional and ethical judgement will need to be exercised, together with the integration of technical knowledge when addressing business reporting issues in a business context.

Learners will be required to adopt either a stakeholder or an external focus in answering questions and to demonstrate personal skills such as problem solving, dealing with information and decision making. Learners will have to demonstrate communication skills appropriate to the scenario.

The paper also deals with specific professional knowledge appropriate to the preparation and presentation of consolidated and other financial statements from accounting data, to conform with accounting standards.

The paper will comprise two sections:

Section A consists of two scenario based questions that will total 50 marks. The first question, worth 30 marks, will be based on the financial statements of group entities, or extracts thereof, and is also likely to require consideration of some financial reporting issues. Candidates should understand that in addition to the consideration of the numerical aspects of group accounting (max 25 marks), a discussion and explanation of these numbers will also be required. The second question, worth 20 marks, will require candidates to consider (i) the

reporting implications and (ii) the ethical implications of specific events in a given scenario.

Two professional marks will be awarded in the ethical issues question in Section A

Section B consists of two questions, which may be scenario or case-study or essay based and will contain both discursive and computational elements. Section B could deal with any aspect of the syllabus but will always include either a full question, or part of a question, that tests the analysis part of the syllabus.

Two professional marks will be awarded in the Section B question that requires analysis.

UK syllabus learners sit an exam that is identical in format to the International syllabus exam. ACCA has indicated that parts of Section B questions in the UK paper will be adapted to assess UK specific content for approximately 15-20 marks.

	Number of marks
Section A	
Two compulsory questions worth 30 and 20 marks	50
Section B	
Two compulsory questions of 25 marks each	50
	—
Total time allowed: 3 hours and 15 minutes	100

Strategic Professional CBE

From March 2020, ACCA introduced Strategic Professional computer based examinations (CBE) in selected locations. Strategic Professional CBE will be extended to other locations over time, across subsequent examination sessions. Once CBE are offered in a location, the paper-based exam will no longer be available. For more information regarding when Strategic Professional CBE will be introduced in your market, please refer to the ACCA Global website.

This Study Text is appropriate for both CBE and paper-based exams. It is essential that learners who will be sitting the CBE become familiar with the CBE environment as part of their exam preparation. For additional support please refer to the ACCA Global website.

Study skills and revision guidance

This section aims to give guidance on how to study for your ACCA exams and to give ideas on how to improve your existing study techniques.

Preparing to study

Set your objectives

Before starting to study decide what you want to achieve – the type of pass you wish to obtain. This will decide the level of commitment and time you need to dedicate to your studies.

Devise a study plan

Determine which times of the week you will study.

Split these times into sessions of at least one hour for study of new material. Any shorter periods could be used for revision or practice.

Put the times you plan to study onto a study plan for the weeks from now until the exam and set yourself targets for each period of study – in your sessions make sure you cover the course, course assignments and revision.

If you are studying for more than one paper at a time, try to vary your subjects as this can help you to keep interested and see subjects as part of wider knowledge.

When working through your course, compare your progress with your plan and, if necessary, re-plan your work (perhaps including extra sessions) or, if you are ahead, do some extra revision/practice questions.

Effective studying

Active reading

You are not expected to learn the text by rote, rather, you must understand what you are reading and be able to use it to pass the exam and develop good practice. A good technique to use is SQ3Rs – Survey, Question, Read, Recall, Review:

- (1) **Survey the chapter** – look at the headings and read the introduction, summary and objectives, so as to get an overview of what the chapter deals with.
- (2) **Question** – whilst undertaking the survey, ask yourself the questions that you hope the chapter will answer for you.
- (3) **Read** through the chapter thoroughly, answering the questions and making sure you can meet the objectives. Attempt the exercises and activities in the text, and work through all the examples.
- (4) **Recall** – at the end of each section and at the end of the chapter, try to recall the main ideas of the section/chapter without referring to the text. This is best done after a short break of a couple of minutes after the reading stage.
- (5) **Review** – check that your recall notes are correct.

You may also find it helpful to re-read the chapter to try to see the topic(s) it deals with as a whole.

Note-taking

Taking notes is a useful way of learning, but do not simply copy out the text. The notes must:

- be in your own words
- be concise
- cover the key points
- be well-organised
- be modified as you study further chapters in this text or in related ones.

Trying to summarise a chapter without referring to the text can be a useful way of determining which areas you know and which you don't.

Three ways of taking notes:

Summarise the key points of a chapter.

Make linear notes – a list of headings, divided up with subheadings listing the key points. If you use linear notes, you can use different colours to highlight key points and keep topic areas together. Use plenty of space to make your notes easy to use.

Try a diagrammatic form – the most common of which is a mind-map. To make a mind-map, put the main heading in the centre of the paper and put a circle around it. Then draw short lines radiating from this to the main sub-headings, which again have circles around them. Then continue the process from the sub-headings to sub-sub-headings, advantages, disadvantages, etc.

Highlighting and underlining – you may find it useful to underline or highlight key points in your study text, but do be selective. You may also wish to make notes in the margins.

Revision

The best approach to revision is to revise the course as you work through it. Also try to leave four to six weeks before the exam for final revision. Make sure you cover the whole syllabus and pay special attention to those areas where your knowledge is weak. Here are some recommendations:

Read through the text and your notes again and condense your notes into key phrases. It may help to put key revision points onto index cards to look at when you have a few minutes to spare.

Review any assignments you have completed and look at where you lost marks – put more work into those areas where you were weak. The SBR examining team produce detailed marking guides at the end of the solutions to past exam questions. These are available in the Exam Kit.

Practise exam standard questions under timed conditions. If you are short of time, list the points that you would cover in your answer and then read the model answer, but do try to complete at least a few questions under exam conditions.

Make sure that you read the ACCA article, 'What is the Examiner Asking?' This will help you to ensure that you fully understand what is required of you in the exam. It can be found here:

<https://www.accaglobal.com/uk/en/student/sa/study-skills/questions.html>

Also practise producing answer plans and comparing them to the model answer.

If you are stuck on a topic find somebody (a tutor) to explain it to you.

Read good newspapers and professional journals, especially ACCA's Student Accountant – this can give you an advantage in the exam.

Ensure you know the structure of the exam – how many questions there are, what types of question you will be expected to answer, and the time you will spend on each question. During your revision attempt all the different styles of questions you may be asked.

Further reading

The examining team have stated the need for learners to read widely.

Technical articles relevant to SBR can be found on the ACCA website at the following address:

<https://www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/strategic-business-reporting/technical-articles.html>

Please be aware that ACCA update their list of examinable documents annually. You should refer to this before undertaking any further reading.

Frameworks

Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss the importance of a conceptual framework in underpinning the production of accounting standards
- Discuss the objectives of financial reporting including disclosure of information that can be used to help assess management's stewardship of the entity's resources and the limitations of financial reporting
- Discuss the nature of the qualitative characteristics of useful financial information
- Explain the roles of prudence and substance over form in financial reporting
- Discuss the high level measurement uncertainty that can make financial information less relevant
- Evaluate the decisions made by management on recognition, derecognition and measurement
- Critically discuss and apply the definitions of the elements of financial statements
- Discuss and apply the definitions of 'fair value' measurement and 'active market'
- Discuss and apply the 'fair value hierarchy'
- Discuss and apply the principles of highest and best use, most advantageous and principal market
- Explain the circumstances where an entity may use a valuation technique.



One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



1 Introduction

This chapter considers two documents issued by the International Accounting Standards Board (the Board) that underpin a range of IFRS and IAS Standards:

- The *Conceptual Framework for Financial Reporting* – used by the Board when developing or revising an IFRS or IAS Standard, and by preparers of financial statements when no relevant IFRS or IAS Standard exists, and
- IFRS 13 *Fair Value Measurement* – used by preparers of financial statements when an IFRS or IAS Standard requires or allows the use of a fair value measurement (with some exceptions).



Progression

You will have seen the content of this chapter in your prior studies. However, the ACCA SBR exam will test it at a much higher level.

2 *Conceptual Framework for Financial Reporting*

Introduction

The importance of a conceptual framework

A conceptual framework is a set of theoretical principles and concepts that underlie the preparation and presentation of financial statements.

If no conceptual framework existed, then accounting standards would be produced on a haphazard basis as particular issues and circumstances arose. These accounting standards might be inconsistent with one another, or perhaps even contradictory.

A strong conceptual framework means that there are principles in place from which all future accounting standards draw. It also acts as a reference point for the preparers of financial statements if no accounting standard governs a particular transaction (although this will be extremely rare).

This section of the text considers the contents of the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) in more detail.

Background

The *Framework for the Presentation and Preparation of Financial Statements* was issued in 1989.

In 2004 the Board and the US Financial Accounting Standards Board (FASB) started a joint project to revise their respective frameworks. As a result of this project the Board issued the *Conceptual Framework for Financial Reporting* in 2010. Most of the text from the 1989 *Framework* was simply rolled over but two chapters were revised. These covered:

- The objective of financial reporting
- The qualitative characteristics of useful financial information.

The Board and the FASB subsequently suspended work on this joint project.

Several criticisms emerged of the 2010 *Conceptual Framework*

- It did not cover certain areas, such as derecognition, and presentation and disclosure
- Guidance in some areas was unclear, such as with regards to measurement uncertainty
- Some aspects were out of date, such as recognition criteria for assets and liabilities.

As a result of criticism, the *Conceptual Framework* was identified as a priority project so, in 2012, the Board restarted this project without the FASB. A Discussion Paper outlining the Board's thinking was published in 2013 and an Exposure Draft of the proposed amendments was published in 2015. Feedback from these documents informed the revised *Conceptual Framework*, which was published in 2018.

The purpose of the *Conceptual Framework*

The purpose of the *Conceptual Framework* is to assist:

- (a) **the Board** when developing new IFRS Standards, helping to ensure that these are based on consistent concepts
- (b) **preparers of financial statements** when no IFRS Standard applies to a particular transaction, or when an IFRS Standard offers a choice of accounting policy
- (c) **all parties** when understanding and interpreting IFRS Standards.

The *Conceptual Framework* is not an accounting standard. It does not override the requirements in a particular IFRS Standard.

The objective of financial reporting

The *Conceptual Framework* states that the purpose of financial reporting is to provide information to current and potential investors, lenders and other creditors that will enable them to make decisions about providing economic resources to an entity.

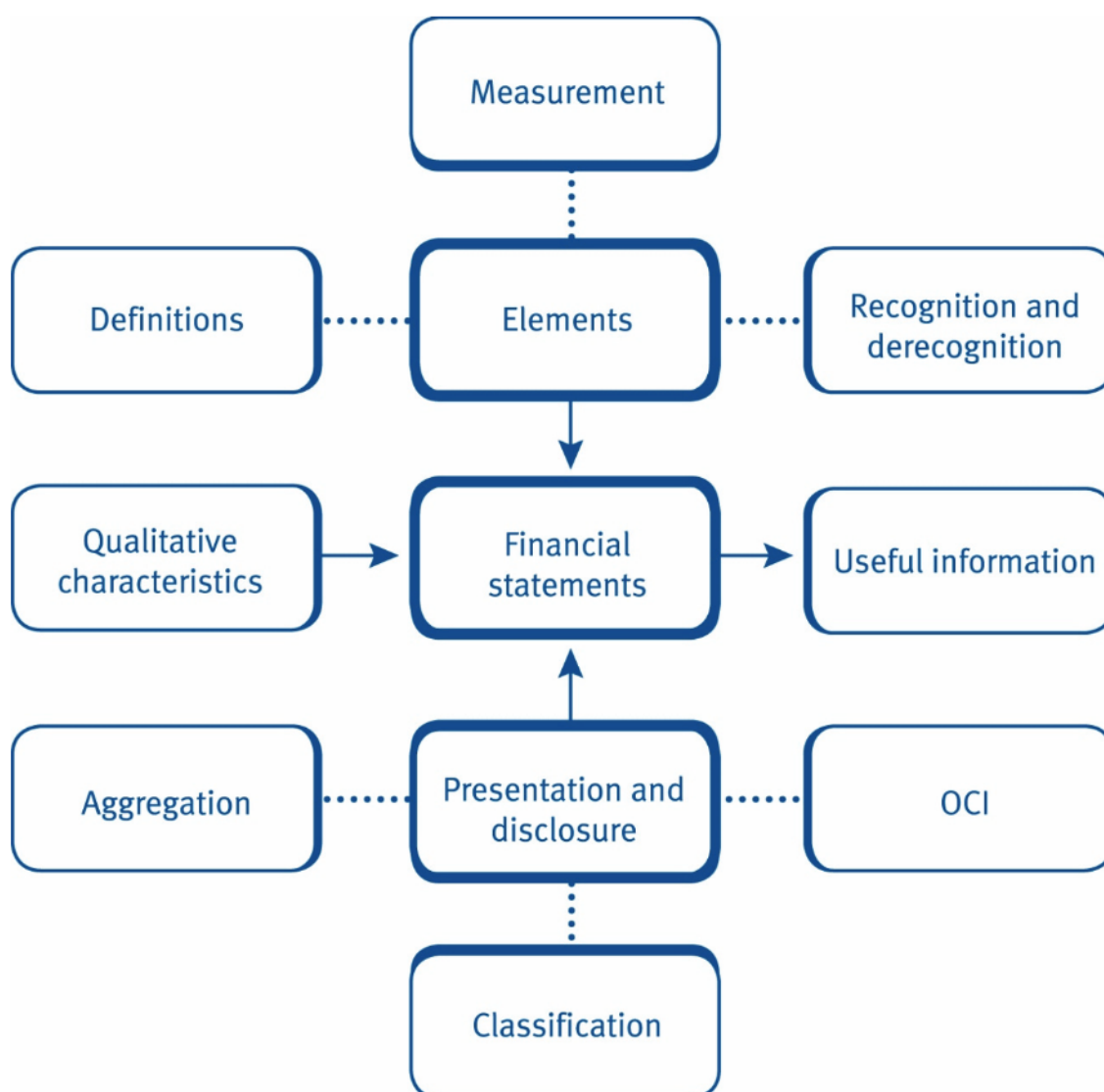
If investors, lenders and creditors are going to make these decisions then they require information that will help them to assess:

- an entity's potential future cash flows, and
- management's stewardship of the entity's economic resources.

To assess an entity's future cash flows, users need information about:

- economic resources of the entity e.g. assets
- economic claims against the entity e.g. liabilities and equity
- changes in economic resources and claims e.g. income and expenses.

Summary of the content of the Conceptual Framework



Qualitative characteristics of useful financial information

Fundamental characteristics

The *Conceptual Framework* states that financial information is only useful if it is:

- relevant
- a faithful representation of an entity's transactions.

Relevance and faithful representation are the **fundamental characteristics** of useful financial information.

1 Relevance

Relevant information will make an impact on the decisions made by users of the financial statements.

Relevance requires management to consider materiality. An item is material if omitting, misstating or obscuring it would influence the economic decisions of users.

2 Faithful representation

A faithful representation of a transaction would represent its economic substance rather than its legal form.

A perfectly faithful representation would be:

- complete
- neutral
- free from error.

The Board note that this is not fully achievable, but that these qualities should be maximised.

When preparing financial reports, preparers should exercise **prudence**. Prudence means that assets and income are not overstated and liabilities and expenses are not understated. However, this does not mean that assets and income should be purposefully understated, or liabilities and expenses purposefully overstated. Such intentional misstatements are not neutral.

Enhancing characteristics

In addition to the two fundamental qualitative characteristics, there are four enhancing qualitative characteristics of useful financial information:

- **Comparability** – investors should be able to compare an entity's financial information year-on-year, and one entity's financial information with another.
- **Timeliness** – older information is less useful.
- **Verifiability** – knowledgeable users should be able to agree that a particular depiction of a transaction offers a faithful representation.
- **Understandability** – information should be presented as clearly and concisely as possible.

Cost constraint

Producing financial reports takes time and costs money.

When developing IFRS Standards, the Board assesses whether the benefits of reporting particular information outweigh the costs involved in providing it.



Cost constraint – an example

IFRS 16 *Leases*, which replaced IAS 17 *Leases*, radically changed lessee accounting by requiring all lessees to recognise an asset and liability at the inception of a lease (unless the lease is short-term or of minimal value). However, IFRS 16 did not change the accounting treatment of leases by lessors. This was because most stakeholders did not believe that the requirements relating to lessors in IAS 17 were 'broken'. The perceived time and costs involved in implementing substantial changes to lessor accounting was therefore believed to outweigh any benefits.

Financial statements and the reporting entity

Financial statements

The *Conceptual Framework* notes that financial statements are a particular type of financial report.

The purpose of financial statements is to provide information to users about an entity's:

- assets
- liabilities
- equity
- income
- expenses.

This information is provided in:

- a statement of financial position
- statements of financial performance
- other statements, such as statements of cash flows and notes.

Financial statements are prepared on the assumption that the entity is a **going concern**. This means that it will continue to operate for the foreseeable future. If this assumption is not accurate, then the financial statements should be prepared on a different basis.

The reporting entity

A reporting entity is one that prepares financial statements (either through choice, or as a result of legal requirements).

Financial statements produced for two or more entities that are not parent/subsidiaries are called 'combined financial statements'. It can be difficult in these circumstances to determine the boundary of the reporting entity. Note that the *Conceptual Framework* does not stipulate how or when to prepare combined financial statements, although the Board may develop a standard on this issue in the future.

Financial statements produced for a reporting entity that comprises a parent company and its subsidiaries are called 'consolidated financial statements'. These financial statements show the parent and its subsidiaries as a single economic entity. This information is important for investors in the parent because their economic returns are dependent on distributions from the subsidiary to the parent.

Unconsolidated financial statements also provide useful information to investors in a parent company (for example, about the level of distributable reserves) but they are not a substitute for information provided in consolidated financial statements.

The elements of financial statements

The elements are the building blocks of financial statements:

- statements of financial position report assets, liabilities and equity
- statements of financial performance report income and expenses.

Economic resource	Asset	'A present economic resource controlled by an entity as a result of a past event' (para 4.3).
Economic claim	Liability	'A present obligation of the entity to transfer an economic resource as a result of a past event' (para 4.26).
	Equity	The residual interest in the net assets of an entity.

Changes in economic resources and claims as a result of financial performance	Income	Increases in assets or decreases in liabilities that result in an increase to equity (excluding contributions from equity holders).
	Expenses	Decreases in assets or increases in liabilities that result in decreases to equity (excluding distributions to equity holders).
Other changes in economic resources and claims		Contributions from, and distributions to, equity holders. Exchanges of assets and liabilities that do not increase or decrease equity.

An economic resource is a '**right that has the potential to produce economic benefits**' (para 4.4).

Recognition and derecognition

Recognition

Items are only recognised in the financial statements if they meet the definition of one of the elements. However, not all items meeting these definitions are recognised.

Elements are recognised if recognition provides users with useful financial information. In other words recognition must provide:

- relevant information
- a faithful representation of the asset or liability, and resulting income, expenses or equity movements.

Recognition might not provide relevant information if there is uncertainty over the existence of the element or if there is a low probability of an inflow or outflow of economic resources.



Recognition – an example

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prohibits recognition of contingent liabilities and assets because it is not probable that resources will flow from or to the reporting entity.

Recognition of an element might not provide a faithful representation if there is a very high degree of measurement uncertainty.

Judgement is required in deciding if recognition of an element is appropriate. This is why specific recognition criteria vary from one IFRS Standard to another.

If an asset or liability is not recognised, disclosures may be required to ensure users fully understand the reporting entity's economic transactions and the implications that these may have on future earnings and future cash flows.



Test your understanding 1 – Bottle

Bottle operates in the publishing industry. The Bottle brand is highly respected and, as a result, the books published by Bottle receive extensive coverage both online and in national and international press. The brand is internally generated and, in accordance with IAS 38 *Intangible Assets*, is not recognised in Bottle's financial statements.

Required:

Discuss the extent to which the accounting treatment of the Bottle brand is consistent with the *Conceptual Framework*.

Derecognition

Derecognition is the removal of some or all of an asset or liability from the statement of financial position. This normally occurs when the entity:

- loses control of the asset, or
- has no present obligation for the liability.

Accounting for derecognition should faithfully represent the changes in an entity's net assets, as well as any assets or liabilities retained.

This is achieved by:

- derecognising any transferred, expired or consumed component
- recognising a gain or loss on the above, and
- recognising any retained component.

Sometimes an entity might appear to have transferred an asset or liability. However, derecognition would not be appropriate if exposure to variations in the element's economic benefits is retained.



Derecognition – an example

An entity sells a building for \$2 million and retains the right to buy it back for \$3 million in five years' time. At the date of sale, the building had a fair value of \$7 million. Property prices are expected to rise.

The entity does not derecognise the building from its statement of financial position. The entity has not lost control over the building because its ability to buy the building back for substantially less than fair value enables it to benefit from future price rises.

The cash received would be recognised as a loan liability.

Measurement

When recognised in the financial statements, elements must be quantified in monetary terms.

The *Conceptual Framework* outlines two broad measurement bases:

- Historical cost
- Current value (this includes fair value, value-in-use, and current cost).

Selecting a measurement base

The information provided to users by the measurement base must be useful. In other words it must be relevant and offer a faithful representation of the transactions that have occurred.

When selecting a measurement basis, the *Conceptual Framework* states that relevance is maximised if the following are considered:

- The characteristics of the asset and/or liability
- The ways in which the asset and/or liability contribute to future cash flows.

This applies to the Board when developing or revising an IFRS Standard. It also applies to preparers of financial statements when applying an IFRS Standard that permits a choice of measurement bases.



Selecting a measurement basis – an example

Mist purchases an investment property in a prime location. Property prices are increasing in this area. As such, the value of the property is susceptible to market factors, and could substantially differ from the initial purchase price paid by Mist.

IAS 40 *Investment Property* offers a choice of accounting policy. Mist might choose:

- The fair value model if they intend to sell the asset because this most faithfully represents the future cash flows they will receive from its eventual disposal
- The cost model if they have no intention of selling the property because this best matches the rental income generated with the cost of the asset.

Note that Mist might have no intention of selling the asset but still conclude that the fair value model provides the most relevant information about the building to financial statement users. This might be because increases in property prices will enable Mist to charge higher rents to its tenants, thus contributing to greater net cash inflows.

Presentation and disclosure

Effective presentation and disclosure

Effective presentation and disclosure is a balance between allowing entities to flexibly report relevant information about their financial performance and position, and requiring information that enables comparisons to be drawn year-on-year and with other entities.

The Board believes that:

- entity specific information is more useful than standardised descriptions
- duplication makes financial information less understandable.

Classification

Classification of an asset or liability into separate components may provide relevant information if the components have different characteristics.



Classification – an example

At the reporting date, Bottled owed \$10 million to a bank.

\$1 million of this loan is due for repayment within 12 months and is presented as a current liability.

The remaining \$9 million is presented as a non-current liability.

Classifying the liability in this way provides additional information to users, which helps them to assess Bottled's future cash flows, as well as its solvency.

Offsetting classifies dissimilar items together and is therefore generally not appropriate.



Classification – an example

Ellipsis has \$3 million in an account held with Animal Bank. This money earns 1% interest per year. The balance is presented in Ellipsis' statement of financial position as a current asset.

Ellipsis also has a \$1 million overdraft in an account held with Sotoro Bank. This incurs an interest charge of 10% a year. This overdraft is presented in Ellipsis' statement of financial position as a current liability.

Ellipsis must not offset its \$3 million cash balance with its \$1 million overdraft e.g. it cannot show a net \$2 million current asset. The cash balance and the overdraft have different characteristics and risks, and offsetting would obscure these differences. Separate classification provides relevant information to the users of the financial statements.

Aggregation

Aggregation refers to the adding together of items that have shared characteristics.

Aggregation is useful because it summarises information that would otherwise be too detailed. However, too much aggregation obscures relevant information.

Different levels of aggregation will be required throughout the financial statements. For example, the statement of profit or loss may be heavily aggregated, but accompanying disclosure notes will disaggregate the information.

Profit or loss and other comprehensive income

The *Conceptual Framework* states that the statement of profit or loss is the primary source of information about an entity's financial performance. As such, income and expenses should normally be recognised in this statement.

When developing or revising standards, the Board notes that it might require an income or expense to be presented in other comprehensive income if it results from remeasuring an item to current value and if this means that:

- profit or loss provides more relevant information, or
- a more faithful representation is provided of an entity's performance.

Income and expenditure included in other comprehensive income should be reclassified to profit or loss when doing so results in profit or loss providing more relevant information. However, the Board may decide that reclassification is not appropriate if there is no clear basis for identifying the amount or timing of the reclassification.



Other comprehensive income – an example

Entity A owns land and buildings that are accounted for using the revaluation model in IAS 16 *Property, Plant and Equipment*. At the reporting date, Entity A revalued these assets from \$250 million to \$300 million. IAS 16 stipulates that the \$50 million gain must be recognised in other comprehensive income.

Property, plant and equipment is not held for trading, but is instead used over more than one period to produce, supply, store and distribute goods. Including this \$50 million gain in profit or loss would not offer a faithful representation of Entity A's financial performance during the period.



Test your understanding 2 – Cryptocurrencies

Cryptocurrencies are digital currencies that operate independently of a central bank. Some businesses now accept cryptocurrencies in place of traditional currencies.

The market price of cryptocurrency is highly volatile. Investors can earn large returns by buying cryptocurrency on an exchange when the quoted price is low and selling on an exchange when the quoted price rises.

Cryptocurrencies have proved problematic with regards to financial reporting because they do not seem to fall within the scope of an issued IFRS or IAS Standard. As such, preparers of financial statements must use the *Conceptual Framework* to devise an accounting treatment that provides useful information to financial statement users.

Required:

Using the *Conceptual Framework*, discuss how an entity might account for an investment in cryptocurrency that it holds to trade.

Criticisms of financial reporting

The *Conceptual Framework* provides a principles-based approach to financial reporting. However, users are increasingly critical of the very nature of financial reporting. As a result, new forms of non-financial reporting have emerged, which are discussed later in this text.

Some of the criticisms of financial reporting are discussed below.

Historical information

The statement of profit or loss shows the performance of the entity over the past reporting period. However, investors are more interested in future profits. Moreover by the time financial statements are published, the information presented will be several months out of date.

Unrecognised assets and liabilities

Some assets and liabilities are not recognised in financial statements prepared using IFRS Standards, such as internally generated goodwill. A company's reputation and its employee's skills play a pivotal role in its success but these are unrepresented on the statement of financial position.

Clutter

Financial reports have been criticised in recent years for becoming increasingly cluttered as a result of extensive disclosure requirements. These disclosures can be very generic and they make it harder for the users to find relevant information.

Financial/non-financial information

Current and past profits and cash flows are not the only determinate of future success. Long-term success is also dependent on how an entity is governed, the risks to which it is exposed and how well these are managed, and whether its business activities are sustainable into the medium and long-term. Financial statements prepared in accordance with IFRS Standards say little about these areas.

Estimates

Financial reporting uses many estimates (e.g. depreciation rates). Estimates are subjective and could be manipulated in order to achieve particular profit targets. The subjective nature of estimates reduces comparability between companies.

The statement of cash flows somewhat compensates for the impact of accounting estimates. However, the cash position of an entity can also be window-dressed (such as by delaying payments to suppliers).

Professional judgement

Financial reporting requires judgement. For example, judgement is required by lessors when classifying a lease as a finance lease or an operating lease. Subjective decisions reduce comparability and increase the risk of bias.

Use of historical cost

Some accounting standards, such as IAS 16 *Property, Plant and Equipment*, permit assets to be measured at historical cost. In times of rising prices, the statement of profit or loss will not show a sustainable level of profit.

Policy choices

Some standards, such as IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Properties*, allow entities to choose between cost and fair value models. This makes it harder for investors to compare financial statements on a like-for-like basis.

3 IFRS 13 *Fair Value Measurement*

Introduction

The objective of IFRS 13 is to provide a single source of guidance for fair value measurement where it is required by a reporting standard, rather than it being spread throughout several reporting standards.

Many accounting standards require or allow items to be measured at fair value. Some examples from your prior studies include:

- IAS 16 *Property, Plant and Equipment*, which allows entities to measure property, plant and equipment at fair value
- IFRS 3 *Business Combinations*, which requires the identifiable net assets of a subsidiary to be measured at fair value at the acquisition date.

Scope

IFRS 13 does not apply to:

- share-based payment transactions (IFRS 2 *Share-based Payments*)
- leases (IFRS 16 *Leases*).



The definition of fair value

Fair value is defined as **'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'** (IFRS 13, para 9).

Market participants are knowledgeable, third parties. When pricing an asset or a liability, they would take into account:

- Condition
- Location
- Restrictions on use.

It should be assumed that market participants are not forced into transactions (i.e. they are not suffering from cash flow shortages).

IFRS 13 notes that there are various approaches to determining the fair value of an asset or liability:

- Market approaches (valuations based on recent sales prices)
- Cost approaches (valuations based on replacement cost)
- Income approaches (valuations based on financial forecasts).

Whatever approach is taken, the aim is always the same – to estimate the price that would be transferred in a transaction with a market participant.

The price

Fair value is a market-based measurement, not one that is entity specific. As such, when determining the price at which an asset would be sold (or the price paid to transfer a liability), observable data from active markets should be used where possible.

An **active market** is a market where transactions for the asset or liability occur frequently.

IFRS 13 classifies inputs into valuation techniques into three levels.

- **Level 1** inputs are quoted prices for identical assets in active markets.
- **Level 2** inputs are observable prices that are not level 1 inputs. This may include:
 - Quoted prices for similar assets in active markets
 - Quoted prices for identical assets in less active markets
 - Observable inputs that are not prices (such as interest rates).
- **Level 3** inputs are unobservable. This could include cash or profit forecasts using an entity's own data.

A significant adjustment to a level 2 input would lead to it being categorised as a level 3 input.

Priority is given to level 1 inputs. The lowest priority is given to level 3 inputs.



Inputs to determine fair value

IFRS 13 gives the following examples of inputs used to determine fair value:

	Asset	Example
Level 1	Equity shares in a listed entity	Unadjusted quoted prices in an active market.
Level 2	Building held and used	Price per square metre for the building from observable market data, such as observed transactions for similar buildings in similar locations.
Level 3	Cash-generating unit	Profit or cash flow forecast using own data.



Test your understanding 3 – Baklava

Baklava has an investment property that is measured at fair value. This property is rented out on short-term leases.

The directors wish to fair value the property by estimating the present value of the net cash flows that the property will generate for Baklava. They argue that this best reflects the way in which the building will generate economic benefits for Baklava.

The building is unique, although there have been many sales of similar buildings in the local area.

Required:

Discuss whether the valuation technique suggested by the directors complies with International Financial Reporting Standards.

Markets

The price received when an asset is sold (or paid when a liability is transferred) may differ depending on the specific market where the transaction occurs.

Principal market

IFRS 13 says that fair value should be measured by reference to the **principal market**.

The principal market is the market with the greatest activity for the asset or liability being measured.

The entity must be able to access the principal market at the measurement date. This means that the principal market for the same asset can differ between entities.

Most advantageous market

If there is no principal market, then fair value is measured by reference to prices in the most advantageous market.

The most advantageous market is the one that maximises the net amount received from selling an asset (or minimises the amount paid to transfer a liability).

Transaction costs (such as legal and broker fees) will play a role in deciding which market is most advantageous. However, fair value is not adjusted for transaction costs because they are a characteristic of the market, rather than the asset.



Test your understanding 4 – Markets

An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date as follows:

	Market 1	Market 2
	\$	\$
Price	26	25
Transaction costs	(3)	(1)
Transport costs	(2)	(2)
	<hr/>	<hr/>
Net price received	21	22
	<hr/>	<hr/>

What is the fair value of the asset if:

- (a) market 1 is the principal market for the asset?**
- (b) no principal market can be determined?**

Non-financial assets

What is a non-financial asset?

The difference between financial and non-financial assets is covered in detail in Chapter 12. Financial assets include:

- Contractual rights to receive cash (such as receivables)
- Investments in equity shares.

Non-financial assets include:

- Property, plant and equipment
- Intangible assets.

The fair value of a non-financial asset

IFRS 13 says that the fair value of a non-financial asset should be based on its **highest and best use**.

The highest and best use of an asset is the use that a market participant would adopt in order to maximise its value.

The current use of a non-financial asset can be assumed to be the highest and best use, unless evidence exists to the contrary.

The highest and best use should take into account uses that are:

- physically possible
- legally permissible
- financially feasible.

IFRS 13 says a use can be legally permissible even if it is not legally approved.



Test your understanding 5 – Five Quarters

Five Quarters has purchased 100% of the ordinary shares of Three Halves and is trying to determine the fair value of the net assets at the acquisition date.

Three Halves owns land that is currently developed for industrial use. The fair value of the land if used in a manufacturing operation is \$5 million.

Many nearby plots of land have been developed for residential use (as high-rise apartment buildings). The land owned by Three Halves does not have planning permission for residential use, although permission has been granted for similar plots of land. The fair value of Three Halves' land as a vacant site for residential development is \$6 million. However, transformation costs of \$0.3 million would need to be incurred to get the land into this condition.

Required:

How should the fair value of the land be determined?



Investor perspective

Below is an extract from a disclosure note about the fair value of an entity's financial assets and liabilities:

Fair value of financial instruments

	Level 1 \$m	Level 2 \$m	Level 3 \$m
Financial asset – traded equities	110	–	–
Financial liability – contingent consideration	–	–	33

The fair values of the traded equities have been determined by reference to market price quotations.

The fair value of contingent consideration is estimated based on the forecast future performance of the acquired business over a timeframe determined as part of the acquisition agreement, discounted as appropriate. Key assumptions include growth rates, expected selling volumes and prices and direct costs during the period.

This disclosure informs investors that the fair value of investments in equities has been derived using level 1 inputs (quoted prices for identical assets in active markets). This measurement required no judgement, eliminating the risk of bias, and can be verified by knowledgeable third parties.

In contrast, the disclosure informs investors that the fair value of the contingent liability has been derived using level 3 inputs. This measurement therefore involved a high level of judgement, increasing the risk of management bias. There is also a risk that the amount the entity eventually pays will differ materially from the year-end carrying amount. For this reason, the disclosure provides additional information about how management have estimated the fair value of the liability, so that the investors can assess the adequacy of the methodology used and reach a conclusion as to whether the level of measurement uncertainty is acceptable to them.

Due to the level of risk, some investors may decide to sell their shares in an entity if its fair value measurements are overly reliant on level 3 inputs.



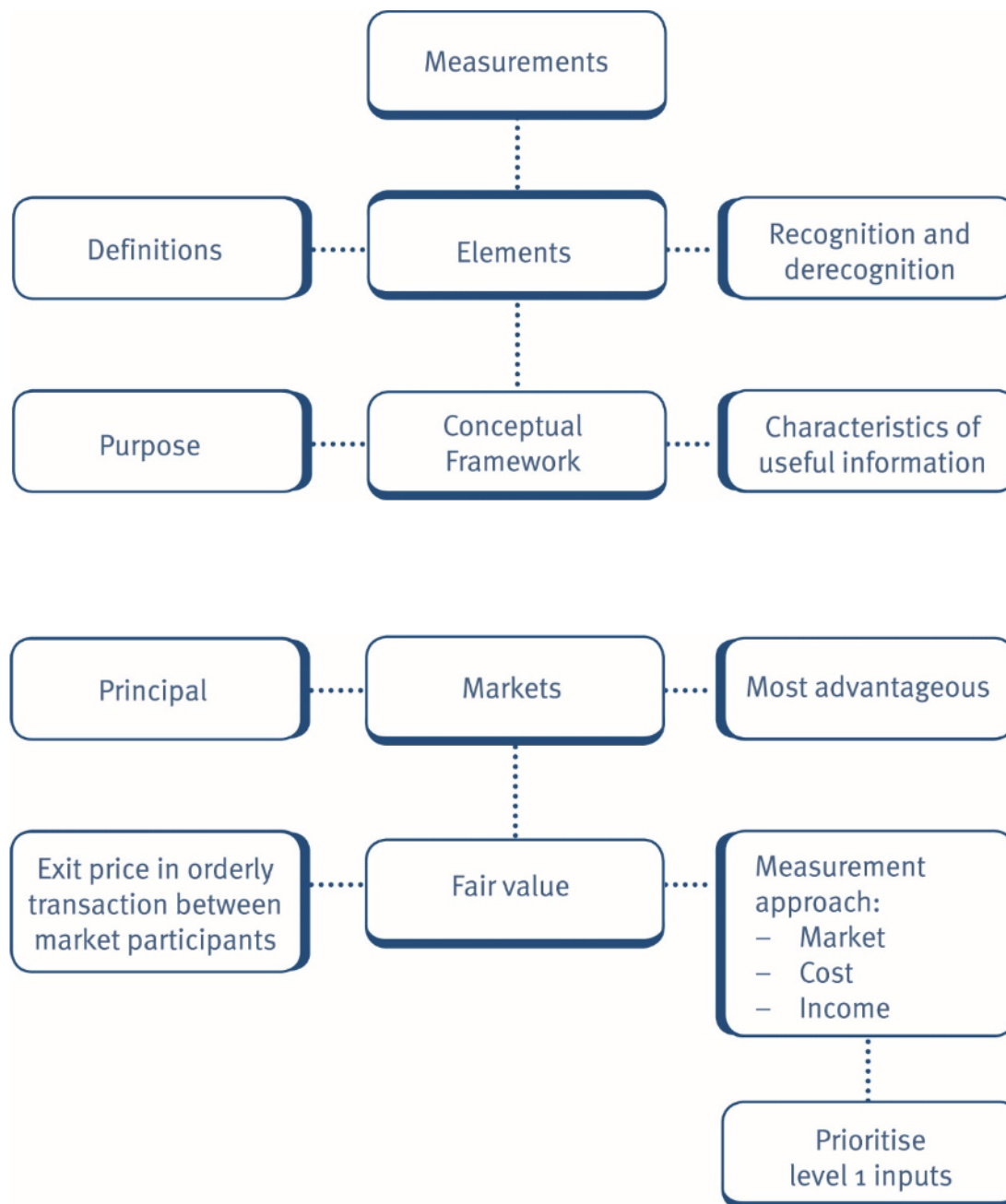
Test your understanding 6 – Conceptual Framework

The *Conceptual Framework* says that the purpose of financial reporting is to provide useful financial information to users of the financial statements.

Required:

Discuss how the application of IFRS 13 enhances the usefulness of financial information. Your answer should refer to the qualitative characteristics of useful financial information.

4 Chapter summary



Test your understanding answers



Test your understanding 1 – Bottle

The brand is an economic resource controlled by Bottle. It has the potential to bring economic benefits because of the exposure that Bottle-branded books receive.

Despite meeting the definition of an element, the brand is not recognised in the financial statements. However, the *Conceptual Framework* states that elements should only be recognised if this provides relevant information, or a faithful representation of the asset or liability. If there is a high degree of measurement uncertainty then recognition may not provide a faithful representation.

The cost of an internally generated brand cannot be reliably measured. This is because the costs of setting up and developing the brand cannot be separated from the operating costs of the business. The fair value of a brand is also very difficult to determine because brands are unique.

Thus, it would seem that the accounting treatment of the brand, per IAS 38 *Intangible Assets*, is consistent with the *Conceptual Framework*.



Test your understanding 2 – Cryptocurrencies

One of the purposes of the *Conceptual Framework* is to assist preparers of financial statements when no IFRS Standard applies to a particular transaction.

The definition of an asset in the *Conceptual Framework* is an economic resource controlled by an entity from a past event. Cryptocurrency meets this definition because it can be traded or used to buy goods and therefore have the potential of producing economic benefits.

Items should be recognised in the financial statements if they meet the definition of an element and if recognition provides relevant information and a faithful representation of the underlying item. If cryptocurrency is traded then information about such investments will help users when assessing an entity's future cash flows. As such, recognition is appropriate.

When measuring elements, the *Conceptual Framework* outlines two broad measurement bases:

- historical cost, and
- current value.

When selecting a measurement basis, the *Conceptual Framework* states that relevance is maximised if the following are considered:

- The characteristics of the asset and/or liability
- The ways in which the asset and/or liability contribute to future cash flows.

In terms of future cash flows, many entities sell investments in cryptocurrency in order to benefit from fair value gains. However, the historical cost of cryptocurrency may differ significantly from its current value. As such, the shareholders of an entity that trades in cryptocurrency are likely to be interested in the current value of the investment because the eventual sale will have a significant impact on future net cash flows. Moreover, under historical cost, information about value changes is not normally reported until disposal. Therefore it would seem that a measurement based on current value – such as fair value – will provide relevant and timely information to shareholders.

The *Conceptual Framework* notes that profit or loss is the primary source of information about an entity's economic performance. However, income and expense might be reported in other comprehensive income if it results from remeasuring an item to current value and if this means that:

- profit or loss provides more relevant information, or
- a more faithful representation is provided of an entity's performance.

Whilst the value of cryptocurrency is highly volatile, that value is likely to be extracted from a short-term sale. As such, it would seem that reporting gains and losses in profit or loss would provide the most relevant information about economic performance in the period.

In conclusion, by applying the *Conceptual Framework*, an appropriate accounting treatment for an investment in cryptocurrency would be to remeasure the investment to fair value at the reporting date and to present the resulting income or expense in the statement of profit or loss.



Test your understanding 3 – Baklava

The directors' estimate of the future net cash flows that the building will generate is a level 3 input. IFRS 13 gives lowest priority to level 3 inputs. These should not be used if level 1 or level 2 inputs exist.

Observable data about the recent sales prices of similar properties is a level 2 input. The fair value of the building should therefore be based on these prices, with adjustments made as necessary to reflect the specific location and condition of Baklava's building.



Test your understanding 4 – Markets

- (a) If Market 1 is the principal market then the fair value would be measured using the price that would be received in that market less transport costs. The fair value would therefore be \$24 (\$26 – \$2). Transaction costs are ignored as they are not a characteristic of the asset.
- (b) If neither market is the principal market for the asset then the fair value would be measured in the most advantageous market. The most advantageous market is the market that maximises the net amount received from the sale.

The net amount received in Market 2 (\$22) is higher than the net amount received in Market 1 (\$21). Market 2 is therefore the most advantageous market. This results in a fair value measurement of \$23 (\$25 – \$2). IFRS 13 specifies that transaction costs play a role when determining which market is most advantageous but that they are not factored into the fair value measurement itself.



Test your understanding 5 – Five Quarters

Land is a non-financial asset. IFRS 13 says that the fair value of a non-financial asset should be based on its highest and best use. This is presumed to be its current use, unless evidence exists to the contrary.

The current use of the asset would suggest a fair value of \$5 million.

However, there is evidence that market participants would be interested in developing the land for residential use.

Residential use of the land is not legally prohibited. Similar plots of land have been granted planning permission, so it is likely that this particular plot of land will also be granted planning permission.

If used for residential purposes, the fair value of the land would be \$5.7 million (\$6m – \$0.3m).

It would seem that the land's highest and best use is for residential development. Its fair value is therefore \$5.7 million.



Test your understanding 6 –*Conceptual Framework*

To be useful, financial information must be relevant and provide a faithful representation of the transaction that an entity has entered into. A completely faithful representation is complete, neutral and free from error.

Measuring items at fair value is often argued to provide relevant information to an entity's stakeholders. However, IFRS 13 does not specify when assets or liabilities should be measured at fair value – this is governed by other IFRS and IAS Standards.

When measuring fair value, IFRS 13 requires entities to use a level 1 input when available – quoted prices for identical assets in active markets. These inputs require no judgement and so the resulting measurement should be neutral.

The prioritisation of observable inputs in IFRS 13 – both level 1 and level 2 – mean that the resulting valuations are verifiable.

IFRS 13 enhances comparability between entities. For example, management estimates – level 3 inputs – should only be used if no other inputs are available. Similarly, IFRS 13 requires entities to measure fair value from the perspective of a market participant, rather than an individual entity, which will aid investors when comparing one entity with another. Requirements to measure fair value using the principal market, and to base the fair value of non-financial assets using the highest and best use, reduce the scope for management bias and ensure that entities are determining fair value consistently.

Requirements to disclose estimation methods when a fair value is determined using level 3 inputs help ensure that financial statements are understandable.

The professional and ethical duty of the accountant

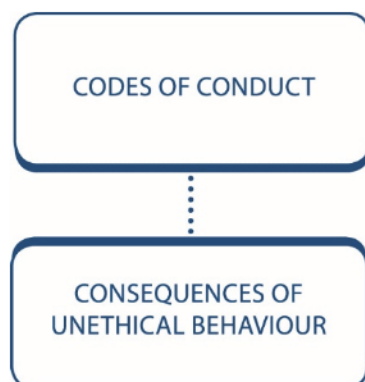
Chapter learning objectives

Upon completion of this chapter you will be able to:

- Appraise and discuss the ethical and professional issues in advising on corporate reporting
- Assess the relevance and importance of ethical and professional issues in complying with accounting standards
- Appraise the potential ethical implications of professional and managerial decisions in the preparation of corporate reports
- Assess the consequences of not upholding ethical principles in the preparation of corporate reports.



One of the PER performance objectives (PO2) is ethics and professionalism. You need to take into account all relevant information and use professional judgement, your personal values and scepticism to evaluate data and make decisions. You should identify right from wrong and escalate anything of concern. You also need to make sure that your skills, knowledge and behaviour are up-to-date and allow you to be effective in your role. Working through this chapter should help you understand how to demonstrate that objective.



1 Introduction

A number of user groups rely on the financial statements to make economic decisions. It is important that these users are not misled.

The ethical beliefs of individual accountants may be too simplistic when dealing with real-life, complex ethical dilemmas. Accountants must study ethics in order to develop skills that help them to decide on the right course of action.



Progression

Ethics was a fundamental component of the Audit and Assurance syllabus. It is also central to Strategic Business Leader and Advanced Audit and Assurance.

2 Approaches to accounting and ethics

Rules

Some national accounting standards are primarily **rules based**. In other words, they provide extensive and detailed guidance about the accounting treatment of particular transactions.

This approach is sometimes criticised for nurturing a 'rule-book mentality'. Complying with the letter of the law rather than the spirit of the accounting standard may actually prevent transactions from being faithfully represented.

Principles

IFRS Standards are often **principles based**, albeit with some detailed rules in place to eliminate uncertainties and to increase comparability.

Principles-based approaches to accounting create ethical challenges because of the professional judgement that accountants are required to exercise. An understanding of ethical principles, such as those contained in the ACCA *Code of Ethics and Conduct*, is essential.

3 Ethical codes

The code of ethics and conduct

The ACCA requires its members to adhere to a code of professional ethics. This provides a set of moral guidelines for professional accountants.

The fundamental principles of this code are:

- (a) **Integrity** – to be straightforward and honest in all professional and business relationships.
- (b) **Objectivity** – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
- (c) **Professional Competence and Due Care** – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- (d) **Confidentiality** – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
- (e) **Professional behaviour** – to comply with relevant laws and regulations and avoid any action that discredits the profession.

Integrity and objectivity

There are times when an accountant may have an incentive to misrepresent the performance or position of an entity:

- **Profit related bonuses:** An accountant might be motivated to maximise profit in the current period in order to achieve their bonus. Alternatively, if current period targets have been met, an accountant might be motivated to shift profits into the next reporting period.
- **Financing:** An entity is more likely to be given a loan if it has valuable assets on which the loan can be secured. An incentive may therefore exist for the accountants to over-state assets on the statement of financial position.
- **Achieving a listing:** A company that is being listed on a stock exchange will want to maximise the amount that it receives from investors. This creates an incentive for the accountants to over-state the assets and profits of a company before it lists.

The *Code of Ethics and Conduct* encourages accountants to act in straightforward and honest ways, and to not let bias impact their judgements.

Professional competence and due care

New accounting standards are frequently issued and older standards are often updated or withdrawn. Accounting knowledge becomes out-of-date very quickly.

In order to comply with the code of ethics, accountants have a responsibility to ensure that they are aware of changes to accounting standards. This is often referred to as CPD (Continuing Professional Development).

CPD involves:

- Reading technical articles
- Attending seminars or presentations
- Attending training courses.

Without up-to-date technical knowledge, it is unlikely that an accountant can produce financial statements that comply with IFRS Standards. Material errors within financial statements will mislead the users.



Conceptual Framework

The *Conceptual Framework* states that financial information is only useful if it is relevant and if it offers a faithful representation of an entity's transactions.

A perfectly faithful representation of an entity's transactions would be complete, neutral, and free from error. Without adherence to the ACCA *Code of Ethics and Conduct*, it is likely that an entity's financial statements will fall short of the standard required by user groups.

4 Insider trading

What is insider trading?

Insider trading is the illegal practice of trading on the stock exchange to one's own advantage through having access to confidential information. An example might be if the finance director of a company sells shares in that company prior to the publication of financial results that are worse than market expectations. Many see this as a violation of the duty to prioritise the interests of other company shareholders.

The ethics of insider trading

It is not unethical for employees of a company to trade in its shares as long as the information they have used to make the investment decisions is largely in the public domain. The ethical dilemmas become trickier to manage for employees and directors who have access to information that is not public.

Legislation in this area varies between countries. In America, key employees and directors of a company who trade in its shares must report this to the regulator.

Insider trading is a breach of the ethical principle of confidentiality. The ACCA *Code of Ethics and Conduct* states that ACCA members must 'not use confidential information acquired as a result of professional and business relationships for the personal advantage of the accountant or for the advantage of a third party.' Insider trading also demonstrates a lack of integrity.

5 Ethics in the digital age

Contemporary challenges

Accountants use and interact with a plethora of new digital technologies. This increases the range of ethical issues that they may face.

Professional competence

Accountants must ensure that they have the knowledge to perform their role adequately. They may be required to become proficient with new software relatively quickly, and to deal with situations, transactions or data that they have not dealt with before.

The increasing use of distributed ledger technology (ledgers with no central data store, where transactions are recorded in multiple places at the same time) demands technical competence. Errors could have serious economic consequences. Professional accountants must be honest about whether they are capable of dealing with such large volumes of sensitive information.

Confidentiality

Accountants have access to lots of data. This data may be internal (employee-related) or external (customer or supplier-related). Data theft can cause financial loss or reputational damage. There may also be legal consequences. Professional accountants must understand local and international laws and regulations around data security and design controls to ensure legal compliance.

Ethics and AI

The accounting profession is making more use of artificial intelligence (AI). For example, AI can:

- extract data from pdfs and spreadsheets and populate reports
- identify anomalies in spending, which may detect or prevent fraud
- detect non-compliance issues (such as errors in expense claims, purchases orders, and sales invoices), which will limit financial loss.

The use of AI allows accounting professionals to allocate more of their time to developing strategy and problem-solving but it also raises ethical issues:

- What will happen to accounting data if AI fails?
- Will AI be a threat to employment?
- Is there a risk of bias in the AI system (e.g. reviewing the expense claims of certain employees)?

6 The impact of ethical and unethical behaviour

Consequences

The journals and magazines of professional institutes regularly include details of professional disciplinary proceedings brought against individual members who were believed to have fallen short of the ethical standards expected of them.

The consequences of unethical behaviour in deliberately presenting incorrect financial information are severe. Many accountants have been fined or jailed for not fulfilling their professional duties.

The consequences for individuals include:

- Fines
- The loss of professional reputation
- Being prevented from acting as a director or officer of a public company in the future
- The possibility of being expelled by a professional accountancy body
- A prison sentence.

Ethics and profits

It is commonly argued that the primary objective of a company is to maximise the wealth of its shareholders. Acting ethically might be seen to contradict this objective. For example, whilst it may be ethical to incur costs associated with looking after the environment, such costs reduce profits.

However, in modern society, companies are considered to be corporate citizens within society. Corporate social responsibility is increasingly important to investors and other stakeholders. It can attract 'green' investors, ethical consumers and employees and so in turn have a positive impact on financial results. Thus, it could be argued that the performance and sustainability of a company may not be maximised unless it behaves in an ethical manner.

7 Exam focus

Question 2 in the SBR exam always tests ethics. This is normally worth between five and ten marks. In addition, two professional marks will be allocated for the application of ethical principles to the scenario and for a recommendation of how the ethical dilemma might be resolved.



Test your understanding 1 – Cookie

The directors of Cookie are very confident about the quality of the products that the company sells. Historically, the level of complaints received about product quality has been low. However, when calculating their warranty provision, they have over-estimated the number of items that will be returned as faulty. The directors believe that this is acceptable because it is important for financial statements to exhibit prudence.

Required:

Discuss the ethical issues raised by the treatment of the warranty provision.



Test your understanding 2 – Totorus

Totorus has a number of investments in listed shares that are designated to be measured at fair value through other comprehensive income. A new ACCA qualified accountant has started work at Totorus and she has discovered that the finance director measures the fair value of these investments as the present value of the expected future dividend receipts. This calculation gives a higher fair value figure than the quoted share price. The finance director has justified this fair value measurement to the accountant on the grounds that Totorus does not trade shares in the short-term and so quoted share prices understate the value that Totorus will realise over the lifetime of these investments.

Required:

Discuss why the finance director's fair value measurement is not in line with IFRS Standards, and discuss the ethical issues that arise.

8 Chapter summary

Codes of ethics

The principles in the ACCA Code of Ethics and Conduct are:

- Integrity
- Objectivity
- Professional competence and due care
- Confidentiality
- Professional behaviour



Consequences of unethical behaviour

The consequences of failing to act ethically are many and can be severe. They include:

- Prison sentence
- Fines or repayments of amounts taken fraudulently
- Loss of professional reputation
- Being prevented from acting in the same capacity in the future
- Investigation by professional accountancy body

Test your understanding answers



Test your understanding 1 – Cookie

Financial statements are important to a range of user groups, such as shareholders, banks, employees and suppliers. Prudence is important because over-stated assets or under-stated liabilities could mislead potential or current investors. However, excessive cautiousness means that the financial performance and position of an entity is not faithfully represented.

A faithful representation is often presumed to have been provided if accounting standards have been complied with. It would appear that the directors are not calculating the provision in line with the requirements of IAS 37, which requires provisions to be recognised at the 'best estimate' of the expenditure to be incurred. This may mean that profit is understated in the current period and then over-stated in subsequent periods.

Professional ethics is a vital part of the accountancy profession and ACCA members are bound by its *Code of Ethics and Conduct*. This sets out the importance of the fundamental principles of confidentiality, objectivity, professional behaviour, integrity, and professional competence and due care.

Integrity is defined as being honest and straight-forward. Over-estimating a provision in order to shift profits from one period to another demonstrates a lack of integrity.

If the provision is being over-stated in order to achieve bonus targets or profit expectations in the next financial period, then this demonstrates a lack of objectivity.

If the directors are unaware of the requirements of IAS 37, then they may not be sufficiently competent. The finance director may need to attend training courses to improve their knowledge.

Financial statements should faithfully represent the transactions that have occurred. Compliance with the ethical code thus encourages accountants to ensure that they are technically capable and sufficiently independent to comply with the requirements of IFRS Standards.



Test your understanding 2 – Totorus

Totorus is using an estimation technique to measure fair value. This is unobservable and so, according to IFRS 13 *Fair Value Measurement*, is a level 3 input. Totorus' intention to hold the asset is not relevant. IFRS 13 states that fair value is a market-based measurement, and not an entity-specific measurement. Totorus should be measuring fair value using the quoted share price. This is a level 1 input, which IFRS 13 prioritises.

Financial statements are important to a range of user groups, such as shareholders, banks, employees and suppliers. These groups require the financial statements to faithfully represent the performance and position of the company so that they can make adequate investment decisions. The public trusts accountants as a result of their professional status and it is vital that this trust is not broken. Professional ethics are therefore a vital part of the accountancy profession and ACCA members are bound by its *Code of Ethics and Conduct*. By following the code of ethics, it is more likely that a faithful representation of the company will be offered because the needs of the users will be prioritised.

If the sole purpose of using the level 3 input is to increase the carrying amount of the investment, then the principles of integrity and objectivity have been compromised.

If the director is unaware of the requirements of IFRS 13, then it could be argued that they are not complying with the ethical principle of professional competence.

Stakeholders are becoming increasingly reactive to the ethical stance of a company. Deliberate falsification of the financial statements could harm the reputation of Totorus. It could also harm the reputation of the accountancy profession as a whole.

The accountant should approach the finance director and remind them of the basic ethical principles and try to persuade them of the need to amend the fair value measurement used. This accountant should document this discussion. Should the finance director remain unmoved, the accountant may wish to contact the ACCA ethical helpline and take legal advice before undertaking any further action.

Performance reporting

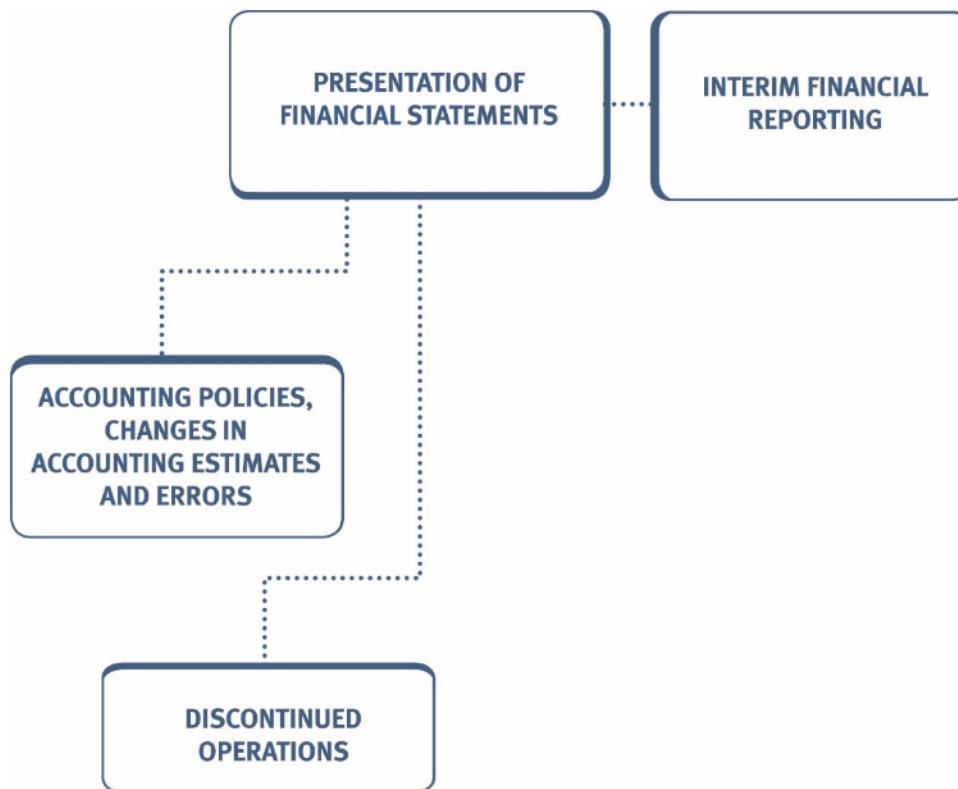
Chapter learning objectives

Upon completion of this chapter you will be able to:

- Critically discuss and apply the reporting of items in the statement of profit or loss and other comprehensive income
- Discuss and apply the judgements required in selecting and applying accounting policies, accounting for changes in estimates and reflecting corrections of prior period errors
- Outline the principles behind the application of accounting policies and measurement in interim reports.



One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



1 Performance reporting

Introduction

This chapter considers four IFRS and IAS Standards that help investors assess the financial performance of an entity:

- IAS 1 *Presentation of Financial Statements* – this outlines recommended formats and minimum content for an entity's financial statements.
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* – this outlines presentation requirements in the statement of profit or loss when an activity is discontinued during the period.
- IAS 8 *Accounting Policies, Changes in Accounting Estimates, and Errors* – this ensures that entities select accounting policies that provide useful information about financial performance and position. Moreover, it provides accounting requirements that enable investors to be able to draw adequate conclusions about financial performance after an entity changes its accounting policies or estimates, or corrects a prior period error.
- IAS 34 *Interim Financial Statements* – this provides the principles to be followed if an entity produces financial statements for a period that is shorter than a full financial year.



Progression

With the exception of IAS 34, you will have seen the content of this chapter in your prior studies. However, the ACCA SBR exam will test it at a much higher level.

2 IAS 1 *Presentation of Financial Statements*

Components of financial statements

According to IAS 1 *Presentation of Financial Statements*, a complete set of financial statements has the following components:

- a statement of financial position
- a statement of profit or loss and other comprehensive income (or statement of profit or loss with a separate statement of other comprehensive income)
- a statement of changes in equity
- a statement of cash flows (discussed in a later chapter)
- accounting policies note and other explanatory notes.

Other reports and statements in the annual report (such as a financial review, or an environmental report) are outside the scope of IAS 1.

The statement of financial position

Assets

IAS 1 says that an entity must classify an asset as current on the statement of financial position if it:

- is realised or consumed during the entity's normal trading cycle, or
- is held for trading, or
- will be realised within 12 months of the reporting date.

All other assets are classified as non-current.

Liabilities

IAS 1 says that an entity must classify a liability as current on the statement of financial position if:

- it is settled during the entity's normal trading cycle, or
- it is held for trading, or
- it will be settled within 12 months of the reporting date
- the entity does not have the right as at the reporting date to defer settlement beyond 12 months (classification is unaffected by the likelihood that an entity will exercise its deferral right).

All other liabilities are classified as non-current.



Test your understanding 1 – Mouse

Mouse is a company that manufactures and sells cheese. It has recently developed a new range of cheese that, at the year end, requires a further 15 months to fully mature. Once matured, the cheese will be sold to retailers.

The directors of Mouse believe that this new cheese should be classified as a non-current asset on the statement of financial position.

Required:

Discuss whether the directors of Mouse are correct.

The statement of profit or loss and other comprehensive income

IAS 1 provides the following definitions:

Other comprehensive income (OCI) are income and expenses recognised outside of profit or loss, as required by particular IFRS Standards.

Total comprehensive income (TCI) is the total of the entity's profit or loss and other comprehensive income for the period.



The *Conceptual Framework*

The *Conceptual Framework* states that the statement of profit or loss is the primary source of information about an entity's financial performance. Income and expenses should normally be recognised in this statement.

When developing standards, the Board notes that it might decide that certain income or expenses should be presented in other comprehensive if they result from remeasuring an item to current value and if this means that:

- profit or loss provides more relevant information, or
- it provides a more faithful representation of an entity's performance.

IAS 1 requires that OCI is classified into two groups as follows:

- items that might be reclassified (or recycled) to profit or loss in subsequent accounting periods:
 - foreign exchange gains and losses arising on translation of a foreign operation (IAS 21)
 - effective parts of cash flow hedging arrangements (IFRS 9)
 - Remeasurement of investments in debt instruments that are classified as fair value through OCI (IFRS 9)

- items that will not be reclassified (or recycled) to profit or loss in subsequent accounting periods:
 - changes in revaluation surplus (IAS 16 & IAS 38)
 - remeasurement components on defined benefit plans (IAS 19)
 - remeasurement of investments in equity instruments that are classified as fair value through OCI (IFRS 9).



The Conceptual Framework

According to the *Conceptual Framework*, income and expenditure included in other comprehensive income should be reclassified to profit or loss when doing so results in profit or loss providing more relevant information. However, when developing or amending an IFRS Standard, the Board may decide that reclassification is not appropriate if there is no clear basis for identifying the amount or timing of the reclassification.

IAS 1 requires an entity to disclose income tax relating to each component of OCI. This may be achieved by either:

- disclosing each component of OCI net of any related tax effect, or
- disclosing OCI before related tax effects with one amount shown for tax.

Entities can prepare one combined statement showing profit or loss for the year and OCI. Alternatively, an entity can prepare a statement of profit or loss and a separate statement of OCI.



The statement of profit or loss and OCI

For illustration, one of the recommended formats from the implementation guidance in IAS 1 is provided below:

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X3

	\$000
Revenue	X
Cost of sales	(X)
	<hr/>
Gross profit	X
Other operating income	X
Distribution costs	(X)
Administrative expenses	(X)
Other operating expenses	(X)
Finance costs	(X)
Share of profit of associates	X
	<hr/>
Profit before tax	X
Income tax expense	(X)
	<hr/>
Profit for the period	X
	<hr/>

Other comprehensive income	
Items that will not be reclassified to profit or loss:	
Changes in revaluation surplus	X
Remeasurement gain on defined benefit pension plans	X
Remeasurement of equity investments designated to be accounted for through OCI	X
Income tax relating to items that will not be reclassified	(X)
	<hr/>
	X
	<hr/>
Items that may be reclassified subsequently to profit or loss:	
Cash flow hedges	X
Exchange differences on translating foreign operations	X
Income tax relating to items that may be reclassified	(X)
	<hr/>
	X
	<hr/>
Total other comprehensive income net of tax for the year	X
	<hr/>
Total comprehensive income for the year	X
	<hr/>
Profit attributable to:	
Owners of the parent	X
Non-controlling interest	X
	<hr/>
	X
	<hr/>
Total comprehensive income attributable to:	
Owners of the parent	X
Non-controlling interest	X
	<hr/>
	X
	<hr/>

Statement of changes in equity

IAS 1 requires all changes in equity arising from transactions with owners in their capacity as owners to be presented separately from non-owner changes in equity. This would include:

- issues of shares
- dividends.

A comparative statement for the prior period must also be published.



Statement of changes in equity

XYZ Group – Statement of changes in equity for the year ended 31 December 20X3

	Equity capt'l	Ret'd earnng's	Transl'n of for'gn operations	Financial assets thru' OCI	Cash flow hdg's	Reval'n surplus	Total
	\$000	\$000	\$000	\$000	\$000	\$000	\$000
Balance at 1 Jan 20X3	X	X	(X)	X	X	–	X
Changes in accounting policy	–	X	–	–	–	–	X
Restated balance	X	X	X	X	X	X	X
Changes in equity for 20X3							
Dividends	–	(X)	–	–	–	–	(X)
Issue of equity capital	X	–	–	–	–	–	X
Total comprehensive income for year	–	X	X	X	X	X	X
Transfer to retained earnings	–	X	–	–	–	(X)	–
Balance at 31 December 20X3	X	X	X	X	X	X	X

In addition to these columns, there should be columns headed:

- (a) Non-controlling interest
- (b) Total equity

General features of financial statements

Going concern



The Conceptual Framework

The *Conceptual Framework* states that financial statements are normally prepared on the assumption that the reporting entity will continue for the foreseeable future. In other words, it is assumed the entity will not enter liquidation, or cease to trade.

IAS 1 states that management should assess whether the going concern assumption is appropriate. Management should take into account all available information about events within at least twelve months of the end of the reporting period.

The following are indicators of a going concern uncertainty:

- A lack of cash and cash equivalents
- Increased levels of overdrafts and other forms of short-term borrowings
- Major debt repayments due in the next 12 months
- A rise in payables days
- Increased levels of gearing
- Negative cash flows, particularly in relation to operating activities
- Disclosures or provisions relating to material legal claims
- Large impairment losses.

Where there is uncertainty, management should consider all available information about the future, including current and expected profitability, debt repayment finance and potential sources of alternative finance. If there is greater doubt or uncertainty, then more work will be required to evaluate whether or not the entity can be regarded as a going concern.

Once management have assessed that there are no material uncertainties as to the ability of an entity to continue for the foreseeable future, the financial statements should be prepared on the assumption that the entity will in fact continue. In other words, the financial statements will be prepared on a going concern basis.

Accruals basis of accounting

The accruals basis of accounting means that transactions and events are recognised when they occur, not when cash is received or paid for them.

Consistency of presentation

The presentation and classification of items in the financial statements should be retained from one period to the next unless:

- it is clear that a change will result in a more appropriate presentation, or
- a change is required by an IFRS or IAS Standard.

Materiality and aggregation

Information is material if omitting, misstating or obscuring it would influence the economic decisions of financial statement users. Materiality judgements should be based on quantitative and qualitative factors.

When assessing materiality, entities should consider the characteristics of the users of its financial statements. It can be assumed that these users have knowledge of business and accounting.

To aid user understanding, financial statements should show material classes of items separately.

Immaterial items may be aggregated with amounts of a similar nature, as long as this does not reduce understandability.

Offsetting

IAS 1 says that assets and liabilities, and income and expenses, should only be offset when required or permitted by an IFRS standard.

Comparative information

Comparative information for the previous period should be disclosed.

Disclosures

Disclosure note presentation

IAS 1 says that entities must present their disclosure notes in a systematic order. This might mean:

- Giving prominence to the most relevant areas
- Grouping items measured in similar ways, such as assets held at fair value
- Following the order in which items are presented in the statement of profit or loss and the statement of financial position.

Compliance with IFRS Standards

Entities should make an explicit and unreserved statement that their financial statements comply with IFRS Standards.

Accounting policies

Entities must produce an accounting policies disclosure note that details its material accounting policies. Accounting policies are likely to be material if related to material transactions and:

- the entity changed the accounting policy during the reporting period, or
- the entity chose its accounting policy from one or more options, or the policy was developed in the absence of a specific IFRS Standard, or
- the accounting policy relates to an area where significant judgements are required, or
- the accounting treatment of the transaction is complex.



Accounting policy disclosure

Distinction is an accountancy tuition provider. It enters into contracts with customers that, in accordance with IFRS 15 *Revenue from Contracts with Customers*, contain two performance obligations as detailed below:

- to provide the customer with a textbook - revenue is recognised at a point in time, when the textbook is provided to the customer
- to provide the customer with five days of lectures - revenue is recognised over-time, as the entity provides the lectures.

Revenue from these contracts is material.

Distinction must decide whether to disclose the above accounting policies. The following factors suggest that disclosure is not required:

- the revenue recognition policy was not changed during the period
- the policies were not chosen from alternatives
- the transactions in question were covered by an IFRS Standard.

However, Distinction's revenue recognition policies:

- relate to an area where judgement is required, such as the allocation of the transaction price to each performance obligation, and the determination of when control of the textbooks transfers to the customer
- were applied in entity-specific ways.

Distinction concludes that disclosing the accounting policies for revenue recognition is necessary for the primary users of its financial statements to understand information in the financial statements. For example, understanding that some revenue is recognised at a point in time and some is recognised over time will help users understand how reported revenue relates to historical and future cash flows. This will help users to assess the entity's future cash flows and thus aid them when making investment decisions.

Sources of uncertainty

An entity should disclose information about the key sources of estimation uncertainty that may cause a material adjustment to assets and liabilities within the next year, e.g. key assumptions about the future.

Reclassification adjustments

Reclassification adjustments are amounts 'recycled' from other comprehensive income to profit or loss.

IAS 1 requires that reclassification adjustments are disclosed, either on the face of the statement of profit or loss and other comprehensive income or in the notes.

Criticisms of the use of other comprehensive income

The accounting treatment and guidance with respect to other comprehensive income (OCI) has been criticised in recent years. Some of these criticisms are as follows:

- Many users ignore OCI, since the gains and losses reported there are not related to an entity's trading cash flows. As a result, material expenses presented in OCI may not be given the attention that they require.
- Reclassification from OCI to profit or loss results in profits or losses being recorded in a different period from the change in the related asset or liability. This contradicts the definitions of income and expenses in the *Conceptual Framework*.

3 IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Definitions

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* says that a discontinued operation is a component of an entity that has been sold, or which is classified as held for sale, and which is:

- a separate line of business (either in terms of operations or location)
- part of a plan to dispose of a separate line of business, or
- a subsidiary acquired solely for the purpose of resale.

An operation is held for sale if its carrying amount will not be recovered principally by continuing use. To be classified as held for sale (and therefore to be a discontinued operation) at the reporting date, it must meet the following criteria.

- The operation is available for sale immediately in its current condition.
- The sale is highly probable and is expected to be completed within one year.
- Management is committed to the sale.
- The operation is being actively marketed.
- The operation is being offered for sale at a reasonable price in relation to its current fair value.
- It is unlikely that the plan will change or be withdrawn.

Presentation

IFRS 5 requires information about discontinued operations to be presented in the financial statements.

- A single amount should be presented on the face of the statement of profit or loss and other comprehensive income that is comprised of:
 - the total of the post-tax profit or loss of discontinued operations
 - the post-tax gain or loss on the measurement to fair value less costs to sell or on the disposal of the discontinued operation.
- An analysis of the single amount described above should be provided on the face of the statement of profit or loss and other comprehensive income or in the notes to the financial statements.
- If a decision to sell an operation is taken after the year-end but before the accounts are approved, this is a non-adjusting event after the reporting date and disclosed in the notes. The operation does not qualify as a discontinued operation at the reporting date and separate presentation is not appropriate.
- In the comparative figures the operations are also shown as discontinued (even though they were not classified as such at the end of the previous year).



Example presentation

Statement of profit or loss (showing discontinued operations as a single amount, with analysis in the notes)

	20X2	20X1
	\$m	\$m
Revenue	100	90
Operating expenses	(60)	(65)
	<hr/>	<hr/>
Profit from operations	40	25
Finance cost	(20)	(10)
	<hr/>	<hr/>
Profit before tax	20	15
Income tax expense	(6)	(7)
	<hr/>	<hr/>
Profit from continuing operations	14	8
Discontinued operations		
Loss from discontinued operations*	(25)	(1)
	<hr/>	<hr/>
Profit/(loss) for the year	(11)	7
	<hr/>	<hr/>

* Analysis of this loss would be given in a disclosure note.



Investor perspective

The *Conceptual Framework* notes that the purpose of financial reporting is to provide information to current and potential investors, lenders and other creditors that will enable them to make decisions about providing economic resources to an entity. To make these decisions, users require information that will help them to assess an entity's future cash flows.

This means that financial statement users are more concerned with future profits than past profits. They will be able to make a better assessment of future profits if they are clearly informed about operations that have been discontinued during the period.



Test your understanding 2 – Discontinued operations

The Portugal group of companies has a financial year-end of 30 June 20X4. The financial statements were authorised three months later. The group is disposing of many of its subsidiaries, each of which is a separate major line of business or geographical area.

- A subsidiary, England, was sold on 1 January 20X4.
- On 1 January 20X4, an announcement was made that there were advanced negotiations to sell subsidiary Switzerland and that, subject to regulatory approval, this was expected to be completed by 31 October 20X4.
- The board has also decided to sell a subsidiary called France. Agents have been appointed to find a suitable buyer but none have yet emerged. The agent's advice is that potential buyers are deterred by the expected price that Portugal hopes to achieve.
- On 10 July 20X4, an announcement was made that another subsidiary, Croatia, was for sale. It was sold on 10 September 20X4.

Required:

Explain whether each of these subsidiaries meets the definition of a 'discontinued operation' as defined by IFRS 5.

4 IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Accounting policies

Accounting policies are the principles and rules applied by an entity which specify how transactions are reflected in the financial statements.

Where an IFRS standard exists in respect of a transaction, the accounting policy is determined by applying that standard.

Some IFRS standards offer a choice in accounting policy. The policy selected should provide the most useful information to financial statement users. Guidance is found in the *Conceptual Framework*.

Where there is no applicable standard or interpretation, management must use its judgement to develop and apply an accounting policy. The accounting policy selected must result in information that is relevant and reliable. Management should refer to

- standards dealing with similar and related issues
- the *Conceptual Framework*.

Provided they do not conflict with the sources above, management may also consider:

- pronouncements from other standard-setting bodies, as long as they use a similar conceptual framework
- other accepted industry practices.



Test your understanding 3 – Judgement

Preparers of financial statements should follow the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when selecting or changing accounting policies, changing estimation techniques, and correcting errors.

Required:

Discuss the role of judgement when selecting an entity's accounting policies.

Changes in accounting policies

An entity should only change its accounting policies if required by a standard, or if it results in more reliable and relevant information.

New accounting standards normally include transitional arrangements on how to deal with any resulting changes in accounting policy.

If there are no transitional arrangements, changes in accounting policy should be applied **retrospectively**. The entity adjusts the opening balance of each affected component of equity, and the comparative figures are presented as if the new policy had always been applied.



The Conceptual Framework

One of the enhancing qualitative characteristics of useful financial information is comparability. The requirement in IAS 8 to adjust changes in accounting policy retrospectively prevents such changes from distorting users' assessments of an entity's financial position and performance year-on-year. This will help when performing trend analysis, thus informing their investment decisions.

Changes in accounting estimates

Accounting estimates are defined as monetary amounts that involve a degree of measurement uncertainty.

Accounting estimates are an essential part of the preparation of financial statements. For example, preparers have to estimate expected credit losses for financial assets, the net realisable value of inventory, and the depreciation expense for property, plant and equipment.

A change in an accounting estimate is **not** the same as a change in accounting policy.

According to IAS 8, a change in accounting estimate must be recognised **prospectively** by including it in the statement of profit or loss and other comprehensive income for the current period and any future periods that are also affected.

Prior period errors

Prior period errors are misstatements and omissions in the financial statements of prior periods as a result of not using reliable information that should have been available.

IAS 8 says that material prior period errors should be corrected **retrospectively** in the first set of financial statements authorised for issue after their discovery. Opening balances of equity, and the comparative figures, should be adjusted to correct the error.

Problems with IAS 8

It has been argued that the requirements of IAS 8 to adjust prior period errors retrospectively may lead to earnings management. By adjusting prior period errors through opening reserves, the impact is never shown within a current period statement of profit or loss.



Test your understanding 4 – Geranium

Geranium's production machinery has always been depreciated on a straight line basis. At the start of the current reporting period, Geranium decides that a depreciation method based on units of production would more accurately represent the resources consumed. At this date, the carrying amount of the production machinery was \$2 million. However, if the machinery had been depreciated using a units of production method since the purchase date, it would instead have a carrying amount of \$1.5 million. The directors wish to charge \$0.5 million additional depreciation to correct this discrepancy.

Required:

Discuss whether the directors of Geranium are correct.

5 IAS 34 *Interim Financial Reporting*

Interim financial reports are prepared for a period shorter than a full financial year. Entities may be required to prepare interim financial reports under local law or listing regulations.

IAS 34 does not require the preparation of interim reports, but sets out the principles that should be followed if they are prepared and specifies their minimum content.



The Conceptual Framework

Financial information is more useful to primary user groups if it is published on a timely basis. Interim financial reports provide up-to-date information on the performance, position and cash flows of an entity for the period-to-date. This information helps users react more quickly to positive or negative changes during the financial year.

Components of interim reports

An interim financial report should include, as a minimum, the following components:

- condensed statement of financial position as at the end of the current interim period, with a comparative statement of financial position as at the end of the previous financial year
- condensed statement of profit or loss and other comprehensive income for the current interim period and cumulatively for the current financial year to date (if, for example the entity reports quarterly), with comparatives for the interim periods (current and year to date) of the preceding financial year
- condensed statement showing changes in equity. This statement should show changes in equity cumulatively for the current year with comparatives for the corresponding period of the preceding financial year

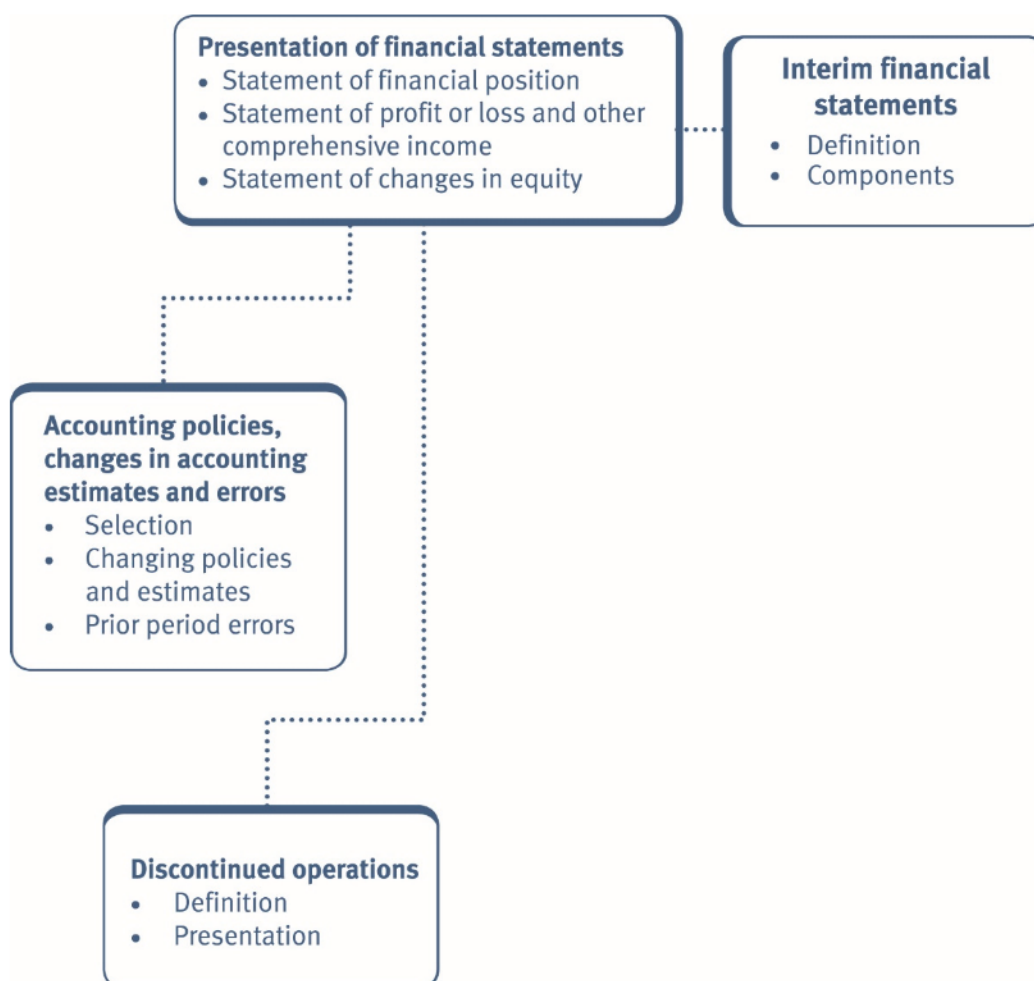
- condensed statement of cash flows cumulatively for the year to date, with a comparative statement to the same date in the previous year
- selected explanatory notes
- basic and diluted EPS should be presented on the face of interim statements of profit or loss and other comprehensive income for those entities within the scope of IAS 33 *Earnings per Share*.

Accounting policies

The same accounting policies should be applied in an entity's interim financial statements as are applied in its annual financial statements.

Measurement should be made on a year-to-date basis. Interim financial statements are likely to rely more heavily on estimation methods than annual financial reports.

6 Chapter summary



Test your understanding answers



Test your understanding 1 – Mouse

IAS 1 *Presentation of Financial Statements* says that an asset should be classified as a current asset if it is sold in the ordinary course of business. Mouse's business model is to manufacture and sell cheese. As such, even though the asset will not be realised within 12 months of the reporting date, the cheese should be classified as inventories and presented as a current asset on the statement of financial position.



Test your understanding 2 – Discontinued operations

England has been sold during the year. It is a discontinued operation per IFRS 5.

Switzerland is a discontinued operation per IFRS 5. There is clear intention to sell, and the sale is highly probable within 12 months.

France is not a discontinued operation per IFRS 5. It does not seem that France is being offered for sale at a reasonable price in relation to its current fair value. The sale does not seem to be highly probable within 12 months.

Croatia is not a discontinued operation per IFRS 5. The conditions for classification as held for sale were not met until after the year end.



Test your understanding 3 – Judgement

Entities should follow the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, when selecting or changing accounting policies. An entity should determine the accounting policy to be applied to an item with direct reference to IFRS Standards. However, an accounting policy need not be applied if the effect of applying it would be immaterial.

Entities should select and apply their accounting policies consistently for similar transactions. For example, similar types of expenses should be presented in the same line in the statement of profit or loss (e.g. administrative expenses). The classification of these expenses should be kept the same from one period to the next.

If a specific IFRS Standard permits different accounting policies for categories of similar items, an entity should apply an appropriate policy for each of the categories in question and apply these accounting policies consistently for each category. For example, for different classes of property, plant and equipment, some may be carried at fair value and some at historical cost.

The *Conceptual Framework* provides guidance when an accounting standard offers a choice of measurement base. Preparers should ensure that the resulting financial information is useful to primary user groups. In other words, the measurement base selected should provide relevant information and offer a faithful representation of the underlying transaction. To provide relevant information, preparers should consider the nature of the asset or liability being measured, and how it generates cash flows for the reporting entity. A measurement base that has a very high level of measurement uncertainty may not provide a faithful representation. Such decisions clearly involve the exercise of judgement and consideration must be given to the information requirements of the entity's user groups. These will vary from one entity to another.

Where IFRS Standards do not specifically apply to a transaction, judgement should be used in developing or applying an accounting policy which will result in useful financial information. In making that judgement, IAS 8 states that entities must refer to guidance in specific IFRS Standards that deal with similar issues and then, subsequently, to definitions and criteria in the *Conceptual Framework*. Additionally, entities can refer to recent pronouncements of other standard setters who use similar conceptual frameworks.



Test your understanding 4 – Geranium

According to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the choice of depreciation method is an accounting estimate. Changes in accounting estimates are dealt with prospectively.

The directors' proposal is incorrect – Geranium is not permitted to post a 'catch up' adjustment of \$0.5 million. Instead, the remaining carrying amount of \$2 million will be depreciated in the current and future periods using the new depreciation method.

Revenue

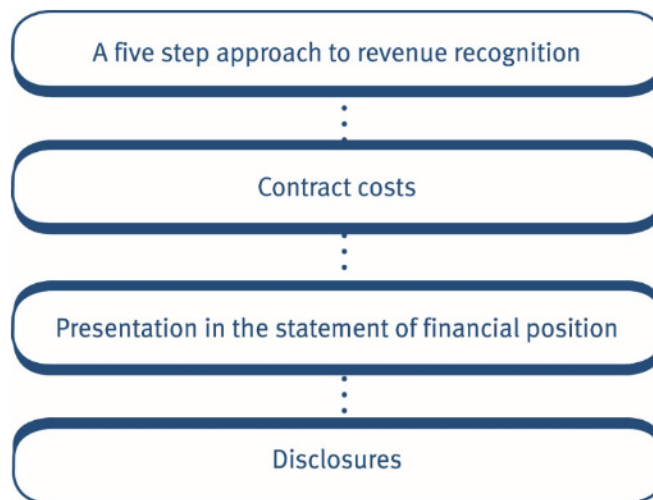
Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss and apply the criteria that must be met before an entity can apply the revenue recognition model
- Discuss and apply the accounting requirements relating to revenue earned from a contract with a customer
- Apply the criteria for recognition of contract costs as an asset
- Discuss and apply the recognition and measurement of revenue including performance obligations satisfied over time, sale with a right of return, consignment arrangements, warranties, variable consideration, principal versus agent considerations and non-refundable up-front fees.



One of the PER performance objectives (PO6) is to record and process transactions and events. You need to use the right accounting treatments for transactions and events. These should be both historical and prospective – and include non-routine transactions. Working through this chapter should help you understand how to demonstrate that objective.



1 IFRS 15 *Revenue from Contracts with Customers*



Revenue is income arising in the course of an entity's normal trading or operating activities.

'Revenue' presented in the statement of profit or loss should not include proceeds from the sale of non-current assets or sales tax.



Investor perspective

An entity's revenue figure is arguably the most important factor to consider when assessing its financial performance. As a performance metric, revenue is generally well understood by users of the financial statements. Revenue is used when assessing market share, and also forms the basis for many key financial statement ratios (such as gross profit margin).

The old revenue recognition standard (IAS 18 *Revenue*) was heavily criticised for containing principles that were difficult to apply to all but the most simple of transactions, and for lacking guidance in many key areas. This problem was exacerbated as entities entered into increasingly complex transactions. Many accounting scandals involved the manipulation of revenue, highlighting the fact that IAS 18 was not up to scratch.

For this reason, the Board viewed the development of IFRS 15 *Revenue from Contracts with Customers* as an extremely important project. IFRS 15, which was issued in 2014, provides a comprehensive and robust revenue recognition model. This should improve the comparability of revenue recognition across entities, enabling investors to make better and more informed decisions.



Progression

You will have studied revenue in your prior studies but SBR will examine much more complicated scenarios. Remember that revenue recognition is a key audit risk and so may feature in Advanced Audit and Assurance.



2 Revenue recognition

A five step process

IFRS 15 *Revenue from Contracts with Customers* (para IN7) says that an entity recognises revenue by applying the following five steps:

- 1 **'Identify the contract**
- 2 **Identify the separate performance obligations within a contract**
- 3 **Determine the transaction price**
- 4 **Allocate the transaction price to the performance obligations in the contract**
- 5 **Recognise revenue when (or as) a performance obligation is satisfied.'**

The following illustration will help you to gain an understanding of the basic principles of the IFRS 15 revenue recognition model.



Illustration 1 – The five steps

On 1 December 20X1, Wade receives an order from a customer for a computer as well as 12 months' of technical support. Wade delivers the computer (and transfers its legal title) to the customer on the same day. The customer paid \$420 upfront. If sold individually, the selling price of the computer is \$300 and the selling price of the technical support is \$120.

Required:

Apply the 5 stages of revenue recognition, per IFRS 15, to determine how much revenue Wade should recognise in the year ended 31 December 20X1.



Solution

Step 1 – Identify the contract

There is an agreement between Wade and its customer for the provision of goods and services.

Step 2 – Identify the separate performance obligations within a contract

There are two performance obligations (promises) within the contract:

- The supply of a computer
- The supply of technical support.

Step 3 – Determine the transaction price

The total transaction price is \$420.

Step 4 – Allocate the transaction price to the performance obligations in the contract

Based on standalone selling prices, \$300 should be allocated to the sale of the computer and \$120 should be allocated to the technical support.

Step 5 – Recognise revenue when (or as) a performance obligation is satisfied

Control over the computer has been passed to the customer so the full revenue of \$300 allocated to the supply of the computer should be recognised on 1 December 20X1.

The technical support is provided over time, so the revenue allocated to this should be recognised over time. In the year ended 31 December 20X1, revenue of \$10 ($1/12 \times \120) should be recognised from the provision of technical support.

Note: the SBR exam is unlikely to require you to apply all five steps to a transaction. Exam questions will most likely focus on one or two of these steps. Few marks are awarded for knowledge regurgitation. Marks will instead be awarded for knowledge and application of the **relevant** steps.

The five steps of revenue recognition will now be considered in more detail.

Step 1: Identify the contract

IFRS 15 says that a contract is an agreement between two parties that creates rights and obligations. A contract does not need to be written.

An entity can only account for revenue from a contract if it meets the following criteria:

- the parties have approved the contract and each party's rights can be identified
- payment terms can be identified
- the contract has commercial substance
- it is probable that the entity will be paid.



The contract

Aluna has a year end of 31 December 20X1.

On 30 September 20X1, Aluna signed a contract with a customer to provide them with an asset on 31 December 20X1. Control over the asset passed to the customer on 31 December 20X1. The customer will pay \$1 million on 30 June 20X2.

By 31 December 20X1, as a result of changes in the economic climate, Aluna did not believe it was probable that it would collect the consideration that it was entitled to. Therefore, the contract cannot be accounted for and no revenue should be recognised.

Step 2: Identifying the separate performance obligations within a contract

Performance obligations

Performance obligations are promises to transfer distinct goods or services to a customer.

Some contracts contain more than one performance obligation. For example:

- An entity may enter into a contract with a customer to sell a car, which includes one year's free servicing and maintenance.
- An entity might enter into a contract with a customer to provide 5 lectures, as well as to provide a textbook on the first day of the course.

Distinct performance obligations within a contract must be identified. A promised good or service is distinct if:

- the customer can benefit from the good or service on its own or by using resources that are readily available, and
- the promise to provide the good or service is separately identifiable from other contractual promises.



Identifying performance obligations – construction of a school

Starling entered into a contract to build a school for one of its customers. To fulfil the contract, Starling must provide various services, such as clearing the site, laying foundations, procuring the materials, construction, wiring of the building, installation of equipment, and decoration.

The customer can benefit from each of these services individually, evidenced by the fact that these services could be purchased separately from a range of entities. However the services are not separately identifiable because Starling is being contracted to significantly integrate them into an identified output (a school).

As such, Starling accounts for all of the promised services as a single performance obligation.

Principals and agents

An entity must decide the nature of each performance obligation. IFRS 15 (para B34) says this might be:

- **'to provide the specified goods or service itself (i.e. it is the principal), or**
- **to arrange for another party to provide the goods or service (i.e. it is an agent)'.**

An entity is the principal if it controls the good or service before it is transferred to the buyer.

If an entity is an agent, revenue is recognised based on the fee it is entitled to.



Principals and agents

Deals4U operates a website that enables customers to purchase computer equipment from a range of suppliers. The suppliers deliver the goods directly to the customers. When a good is purchased via the website, Deals4U earns a commission at a rate of 8% of the sales price. Sales prices are set by the supplier. Customers pay when they place the order. All orders are non-refundable.

Deals4U is an agent because it does not control the computer equipment. Control belongs to the supplier, who sets the prices for its goods and is responsible for fulfilling the orders.

As an agent, Deals4U will recognise revenue based on the commission it is entitled to.

Warranties

Most of the time, a warranty is assurance that a product will function as intended. If this is the case, then the warranty will be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

If the customer has the option to purchase the warranty separately, then it should be treated as a distinct performance obligation. This means that a portion of the transaction price must be allocated to it (see step 4).

Step 3: Determining the transaction price

IFRS 15 defines the transaction price as the amount of consideration the entity expects in exchange for satisfying a performance obligation. Sales tax is excluded.

When determining the transaction price, the following must be considered:

- variable consideration
- significant financing components
- non-cash consideration
- consideration payable to a customer.

Variable consideration

If a contract includes variable consideration then an entity must estimate the amount it will be entitled to.

IFRS 15 says that this estimate **'can only be included in the transaction price if it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty is resolved'** (IFRS 15, para 56).



Test your understanding 1 – Bristow

On 1 December 20X1, Bristow provides a service to a customer for the next 12 months. The consideration is \$12 million. Bristow is entitled to an extra \$3 million if, after twelve months, the number of mistakes made falls below a certain threshold.

Required:

Discuss the accounting treatment of the above in Bristow's financial statements for the year ended 31 December 20X1 if:

- (a) **Bristow has experience of providing identical services in the past and it is highly probable that the number of mistakes made will fall below the acceptable threshold.**
- (b) **Bristow has no experience of providing this service and is unsure if the number of mistakes made will fall below the threshold.**

Note that if a product is sold with a right to return it then the consideration is variable. The entity must estimate the variable consideration and decide whether or not to include it in the transaction price.

The refund liability should equal the consideration received (or receivable) that the entity does not expect to be entitled to.



Test your understanding 2 – Nardone

Nardone enters into 50 contracts with customers. Each contract includes the sale of one product for \$1,000. The cost to Nardone of each product is \$400. Cash is received upfront and control of the product transfers on delivery. Customers can return the product within 30 days to receive a full refund. Nardone can sell the returned products at a profit.

Nardone has significant experience in estimating returns for this product. It estimates that 48 products will not be returned.

Required:

How should the above transaction be accounted for?

Financing

In determining the transaction price, an entity must consider if the timing of payments provides the customer or the entity with a financing benefit.

IFRS 15 provides the following indications of a significant financing component:

- the difference between the amount of promised consideration and the cash selling price of the promised goods or services
- the length of time between the transfer of the promised goods or services to the customer and the payment date.

If there is a financing component, then the consideration receivable needs to be discounted to present value using the rate at which the customer borrows money.



Test your understanding 3 – Rudd

Rudd enters into a contract with a customer to sell equipment on 31 December 20X1. Control of the equipment transfers to the customer on that date. The price stated in the contract is \$1 million and is due on 31 December 20X3.

Market rates of interest available to this particular customer are 10%.

Required:

Explain how this transaction should be accounted for in the financial statements of Rudd for the year ended 31 December 20X1.

Non-cash consideration

Any non-cash consideration is measured at fair value.

If the fair value of non-cash consideration cannot be estimated reliably then the transaction is measured using the stand-alone selling price of the good or services promised to the customer.



Test your understanding 4 – Dan and Stan

Dan sold a good to Stan. Control over the good was transferred on 1 January 20X1. The consideration received by Dan was 1,000 shares in Stan with a fair value of \$4 each. By 31 December 20X1, the shares in Stan had a fair value of \$5 each.

Required:

How much revenue should be recognised from this transaction in the financial statements of Dan for the year ended 31 December 20X1?

Consideration payable to a customer

If consideration is paid to a customer in exchange for a distinct good or service, then it should be accounted for as a purchase transaction.

Assuming that the consideration paid to a customer is not in exchange for a distinct good or service, an entity should account for it as a reduction of the transaction price.



Test your understanding 5 – Golden Gate

Golden Gate enters into a contract with a major chain of retail stores. The customer commits to buy at least \$20 million of products over the next 12 months. The terms of the contract require Golden Gate to make a payment of \$1 million to compensate the customer for changes that it will need to make to its retail stores to accommodate the products.

By the 31 December 20X1, Golden Gate has transferred products with a sales value of \$4 million to the customer.

Required

How much revenue should be recognised by Golden Gate in the year ended 31 December 20X1?

Step 4: Allocate the transaction price

The total transaction price should be allocated to each performance obligation in proportion to stand-alone selling prices.

The best evidence of a stand-alone selling price is the observable price when the good or service is sold separately.

If a stand-alone selling price is not directly observable then it must be estimated. Observable inputs should be maximised whenever possible.

If a customer is offered a discount for purchasing a bundle of goods and services, then the discount should be allocated across all performance obligations within the contract in proportion to their stand-alone selling prices (unless observable evidence suggests that this would be inaccurate).



Test your understanding 6 – Shred

Shred sells a machine and one year's free technical support for \$100,000. The sale of the machine and the provision of technical support have been identified as separate performance obligations. Shred usually sells the machine for \$95,000 but it has not yet started selling technical support for this machine as a stand-alone product. Other support services offered by Shred attract a mark-up of 50%. It is expected that the technical support will cost Shred \$20,000.

Required:

How much of the transaction price should be allocated to the machine and how much should be allocated to the technical support?

Step 5: Recognise revenue

Customer payment is not the trigger point for the recognition of revenue, even if such payments non-refundable. Instead, revenue is recognised when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer.

An entity must determine at contract inception whether it satisfies the performance obligation over time or satisfies the performance obligation at a point in time.

IFRS 15 (para 35) states that an entity satisfies a performance obligation over time if **one** of the following criteria is met:

- (a) **'the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs**
- (b) **the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced, or**
- (c) **the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date'.**

If a performance obligation is satisfied over time, then revenue is recognised over time based on progress towards the satisfaction of that performance obligation.



Test your understanding 7 – Evans

On 1 January 20X1, Evans enters into a contract with a customer to provide monthly payroll services. Evans charges \$120,000 per year.

Required:

What is the accounting treatment of the above in the financial statements of Evans for the year ended 30 June 20X1?



Test your understanding 8 – Crawford

On 31 March 20X1, Crawford enters into a contract to construct a specialised factory for a customer. The customer paid an upfront deposit which is only refundable if Crawford fails to complete construction in line with the contract. The remainder of the price is payable when the customer takes possession of the factory. If the customer defaults on the contract before completion of the factory, Crawford only has the right to retain the deposit.

Required:

Should Crawford recognise revenue from the above transaction over time or at a point in time?

Methods of measuring progress towards satisfaction of a performance obligation include:

- output methods (such as surveys of performance, or time elapsed)
- input methods (such as costs incurred as a proportion of total expected costs).

If progress cannot be reliably measured then revenue can only be recognised up to the recoverable costs incurred.



Test your understanding 9 – Baker

On 1 January 20X1, Baker enters into a contract with a customer to construct a specialised building for consideration of \$2 million plus a bonus of \$0.4 million if the building is completed within 18 months. Estimated costs to construct the building are \$1.5 million. If the contract is terminated by the customer, Baker can demand payment for the costs incurred to date plus a mark-up of 30%. On 1 January 20X1, as a result of factors outside of its control, such as the weather and regulatory approval, Baker is not sure whether the bonus will be achieved.

At 31 December 20X1, Baker is still unsure whether the bonus target will be met. Baker decides to measure progress towards completion based on costs incurred. Costs incurred on the contract to date are \$1.0 million.

Required:

How should Baker account for this transaction in the year ended 31 December 20X1?

If a performance obligation is not satisfied over time then it is satisfied at a point in time. The entity must determine the point in time at which a customer obtains control of a promised asset.

An entity controls an asset if it can direct its use and obtain most of its remaining benefits. Control also includes the ability to prevent other entities from obtaining benefits from an asset.

IFRS 15 (para 38) provides the following indicators of the transfer of control:

- **'The entity has a present right to payment for the asset**
- **The customer has legal title to the asset**
- **The entity has transferred physical possession of the asset**
- **The customer has the significant risks and rewards of ownership of the asset**
- **The customer has accepted the asset'.**



Test your understanding 10 – Clarence

On 31 December 20X1, Clarence delivered the January edition of a magazine (with a total sales value of \$100,000) to a supermarket chain. Legal title remains with Clarence until the supermarket sells a magazine to the end consumer. The supermarket will start selling the magazines to its customers on 1 January 20X2. Any magazines that remain unsold by the supermarket on 31 January 20X2 are returned to Clarence.

The supermarket will be invoiced by Clarence in February 20X2 based on the difference between the number of issues they received and the number of issues that they return.

Required:

Should Clarence recognise revenue from the above transaction in the year ended 31 December 20X1?

Consignment sales

Sometimes an entity delivers its products to a dealer (or distributor) and then the dealer will make the sale to the end consumer. The terms and conditions associated with the transaction between the first entity and the dealer must be assessed to determine whether a sale has occurred.

If control of the good has not passed to the dealer then the transaction is known as a **consignment arrangement** and revenue should not be recognised.

Key indications that the transaction is a consignment arrangement include the following:

- The product is controlled by the entity until a specified event happens e.g. the dealer selling the product to a customer or the expiration of a specified period
- The entity can require the return of the product
- The dealer has no unconditional obligation to pay for the product.



Test your understanding 11 – Gazebo

Gazebo is a company that sells furniture to garden centres. Gazebo retains legal title until the garden centre sells the furniture to the end customer, at which point the garden centre has an obligation to pay Gazebo. The garden centre can return unsold products to Gazebo and Gazebo can recall unsold products at any point.

Required:

Discuss when Gazebo should recognise revenue from the above transactions?

3 Contract modifications

A contract modification is a change in the scope or price of a contract.

The modification is accounted for as a **separate contract** if:

- The scope of the contract increases because of the addition of distinct goods or services, and
- The price increases by an amount that reflects the stand-alone selling prices of the additional goods or services.

If not accounted for as a separate contract, the modification will be accounted for as:

- **the termination of the existing contract and the creation of a new contract** if the remaining goods are distinct from those transferred before the modification. The transaction price for this new contract is the total of
 - the original consideration unrecognised, and
 - the additional consideration promised from the modification.
- **part of the original contract**, if the remaining goods and services are not distinct from those transferred before the modification and so form part of a single performance obligation. This modification will impact the contract price and the stage of contract completion. It is dealt with by adjusting the amount of cumulative revenue recognised at the modification date.



Modifications – remaining goods and services not distinct

The reporting entity, a construction company, enters into a contract to construct a commercial building for another company. One year later, both companies agree to modify the contract by changing the floor plan of the building. This results in an increase to the contract price.

The remaining goods and services to be provided under the modified contract are not distinct from the services transferred before the date of contract modification. This is because the contract still contains one performance obligation (i.e. to construct a commercial building).

Consequently, the reporting entity accounts for the contract modification as if it was part of the original contract. A cumulative catch-up adjustment will be required.



Test your understanding 12 – Salty

Salty enters into a contract to supply 1,000 products to Sweet for \$60 each. The products are transferred over an eight month period, and control passes on delivery. After Salty has transferred 700 products the contract is modified to require an additional 200 products to be transferred (i.e. 1,200 in total). The price for the additional 200 products is \$57, which is the standalone selling price at the date of the contract modification.

By the reporting date, Salty has transferred 900 products in total to Sweet.

Required:

- (a) **Discuss, with calculations, how much revenue should be recognised in relation to the above by the reporting date.**
- (b) **Discuss, with calculations, how much revenue should be recognised in relation to the above by the reporting date if the contract specified a price of \$40 for the additional 200 products. Assume the normal standalone selling price at the modification date is \$57.**

4 Contract costs

IFRS 15 says that the following costs must be recognised as an asset (i.e. capitalised):

- The costs of obtaining a contract. This must exclude costs that would have been incurred regardless of whether the contract was obtained or not (such as some legal fees, or the costs of travelling to a tender).
- The costs of fulfilling a contract if they do not fall within the scope of another standard (such as IAS 2 *Inventories*) and the entity expects them to be recovered.

The capitalised costs of obtaining and fulfilling a contract will be amortised to the statement of profit or loss as revenue is recognised.

General costs, and costs of wasted labour and materials, are expensed to profit or loss as incurred.



Test your understanding 13 – Strangers

Strangers offers consultancy services. It incurred the following costs on a successful contract bid:

	\$
External fees incurred researching potential customer	30,000
Travel costs to deliver proposal	20,000
Commission to sales staff for winning the bid	15,000

Required:

Discuss which of the above costs can be capitalised in accordance with IFRS 15.

5 Presentation on the statement of financial position

When an entity has recognised revenue before it has received consideration, then it should recognise either:

- a receivable if the right to the consideration is unconditional, or
- a contract asset.

An entity has an unconditional right to receive consideration if only the passage of time is required before payment is due.

A contract liability should be recognised if the entity has received consideration (or has an unconditional right to receive consideration) before the related revenue has been recognised.

6 Disclosures

IFRS 15 requires an entity to disclose

- revenue recognised from contracts with customers
- contract balances and assets recognised from costs incurred obtaining or fulfilling contracts
- significant judgements used, and any changes in judgements.

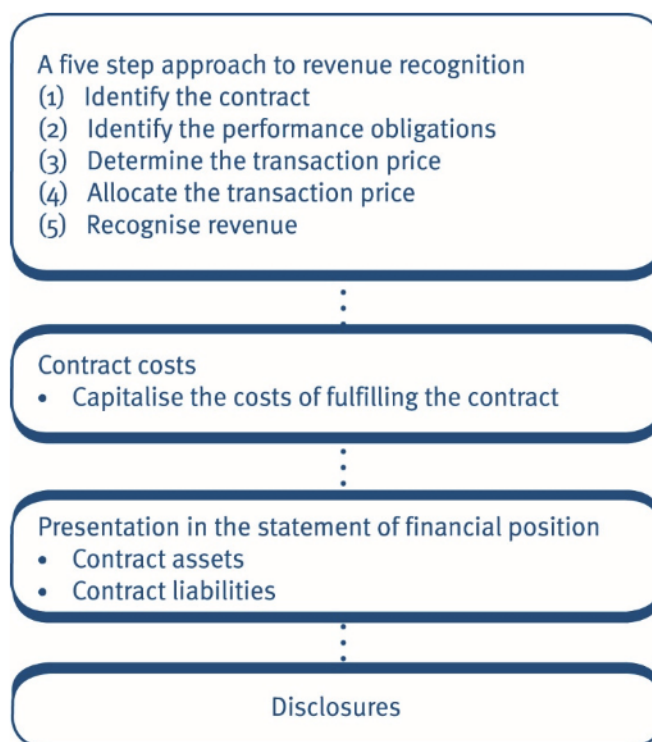
7 Judgement

Management judgement is required throughout the revenue recognition process. For example:

- Contracts with customers do not need to be in writing but may arise through customary business practice. An entity must therefore ascertain whether it has a constructive obligation to deliver a good or service to a customer.
- A contract can only be accounted for if it is probable that the entity will collect the consideration that it is entitled to. Whether benefits are probable is, ultimately, a judgement.
- The entity must identify distinct performance obligations in a contract. However, past performance may give rise to expectations in a customer that goods or services not specified in the contract will be transferred. The identification of distinct performance obligations thus relies on management judgement about both contract terms, and the impact of the entity's past behaviour on customer expectations.
- Variable consideration should be included in the transaction price if it is highly probable that a significant reversal in the amount of cumulative revenue recognised to date will not occur. This may involve making judgements about whether performance related targets will be met.
- The transaction price must be allocated to distinct performance obligations, based on observable, standalone selling prices. However, estimation techniques must be used if observable prices are not available.
- If a performance obligation is satisfied over time, revenue is recognised based on progress towards the completion of the performance obligation. There are various ways to measure completion, using either input or output methods, and the entity must determine which one most faithfully represents the transaction.
- If a performance obligation is satisfied at a point in time, the entity must use judgement to ascertain the date at which control of the asset passes to the customer.

These judgements increase the risk that the management of an entity could manipulate its profits. Adherence to the ACCA ethical code is, therefore, vital.

8 Chapter summary



Test your understanding answers



Test your understanding 1 – Bristow

The \$12 million consideration is fixed. The \$3 million consideration that is dependent on the number of mistakes made is variable.

Bristow must estimate the variable consideration. It could use an expected value or a most likely amount. Since there are only two outcomes, \$0 or \$3 million, then a most likely amount would better predict the entitled consideration.

- (a) Bristow expects to hit the target. Using a most likely amount, the variable consideration would be valued at \$3 million.

Bristow must then decide whether to include the estimate of variable consideration in the transaction price.

Based on past experience, it seems highly probable that a significant reversal in revenue recognised would not occur. This means that the transaction price is \$15 million (\$12m + \$3m).

As a service, it is likely that the performance obligation would be satisfied over time. The revenue recognised in the year ended 31 December 20X1 would therefore be \$1.25 million ($\$15\text{m} \times 1/12$).

- (b) Depending on the estimated likelihood of hitting the target, the variable consideration would either be estimated to be \$0 or \$3 million.

Whatever the amount, the estimated variable consideration cannot be included in the transaction price because it is not highly probable that a significant reversal in revenue would not occur. This is because Bristow has no experience of providing this service. Therefore, the transaction price is \$12 million.

As a service, it is likely that the performance obligation would be satisfied over time. The revenue recognised in the year ended 31 December 20X1 would be \$1 million ($\$12\text{m} \times 1/12$).



Test your understanding 2 – Nardone

The fact that the customer can return the product means that the consideration is variable.

Using an expected value method, the estimated variable consideration is \$48,000 (48 products × \$1,000). The variable consideration should be included in the transaction price because, based on Nardone's experience, it is highly probable that a significant reversal in the cumulative amount of revenue recognised (\$48,000) will not occur.

Therefore, revenue of \$48,000 and a refund liability of \$2,000 ($\$1,000 \times 2$ products expected to be returned) should be recognised.

Nardone will derecognise the inventory transferred to its customers. However, it should recognise an asset of \$800 (2 products × \$400), as well as a corresponding credit to cost of sales, for its right to recover products from customers on settling the refund liability.



Test your understanding 3 – Rudd

Due to the length of time between the transfer of control of the asset and the payment date, this contract includes a significant financing component.

The consideration must be adjusted for the impact of the financing transaction. A discount rate should be used that reflects the characteristics of the customer i.e. 10%.

Revenue should be recognised when the performance obligation is satisfied.

As such revenue, and a corresponding receivable, should be recognised at \$826,446 ($\$1\text{m} \times 1/1.10^2$) on 31 December 20X1.

The receivable is subsequently accounted for in accordance with IFRS 9 *Financial Instruments*.



Test your understanding 4 – Dan and Stan

The contract contains a single performance obligation.

Consideration for the transaction is non-cash. Non-cash consideration is measured at fair value.

Revenue should be recognised at \$4,000 (1,000 shares × \$4) on 1 January 20X1.

Any subsequent change in the fair value of the shares received is not recognised within revenue but instead accounted for in accordance with IFRS 9 *Financial Instruments*.