Chapter 1

The Pillars of Accounting

Reference: The Framework and IAS 1 (revised September 2007)

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1 Introduction

1.1 Accounting, science and languages

Believe it or not, accounting has much in common with
- Chemistry: there are four very basic elements in chemistry (earth, fire, water and air) and in accounting, there are five very basic elements (assets, liabilities, income, expenses and equity); and
- Language: this perhaps needs more explanation.

Through the ages, very many languages developed; Latin, English, French, Spanish and Zulu, to name but a few. Now English, for instance, is used to communicate information and opinions to other English-speaking people (or to those who are at least able to understand it). Accounting is also a language, but one that is used by accountants to communicate financial information and opinions to other accountants (and, of course, to those other interested parties who are able and willing to *try* to understand it).

In order to communicate effectively in the 'language of English' (as in all other languages), there are certain rules to observe when spelling and pronouncing words and when stringing them together in the right order to make an understandable sentence. When communicating in our 'accounting language', there are similar rules. These rules are set out in detail and are commonly referred to as statements of *generally accepted accounting practice* (GAAP).

1.2 The problem

Technology, such as phones, faxes, email, jet engines and the internet, has made it possible to communicate instantly with people in countries that are thousands of miles away and to physically visit them within a matter of hours. Much of this globe-shrinking technology has been around for many years now, so communication has already begun between countries that, only a few hundred years ago, did not even know of each other's existence. And this includes communication amongst accountants and amongst businesses!

The problem is that with so many different languages, communication between different nationalities can sometimes become almost impossible; picture the scene where an English-speaking New Zealander and a Swahili-speaking East African are trying to have a conversation. Even when speaking the same language, there are some accents that make a conversation between, for instance, an English-speaking American and an English-speaking Briton, just as amusing.

Accounting, as a language, is no different. Almost every country has its own accounting language. The language (GAAP) used in one country is often vastly different to that in another country; so different, in fact, that it is like comparing French with Ndebele. In other cases, however, the differences between two country's GAAP may be relatively minor that it is similar to comparing Dutch with Afrikaans or Scottish with Irish. These differences, however small, will still result in miscommunication. Whereas miscommunication on street level often leads to tragedies ranging from divorce to war, miscommunication between businesses often leads to court cases and sometimes even final liquidation of the businesses.

1.3 The International Harmonisation Project

To avoid this miscommunication, accountants all over the world are joining together to develop a single global accounting language. This amazing process is referred to as the 'International Harmonisation Project'.

Its basic objective is to produce a language that is understandable and of a high quality. The rules of this language are explained in a set of global standards, (referred to as the International Financial Reporting Standards or IFRSs).

The process of harmonisation involves discussion amongst standard setters in any country wishing to be part of the process, during which the reporting processes currently used by these standard setters (their local statements of GAAP) are considered and then the best processes are selected to constitute or form the basis of the new international standard going forward.

Although most countries (108 participating countries as at 5 November 2007, www.iasplus.com) are already using this single language, there are, as can be expected, a few countries who have refused. This project is therefore expected to be a long and politically volatile one, but one which, in the end, will hopefully enable accountants all around the globe to communicate in one language.

All countries that adopt the global accounting language, must comply with these rules (IFRSs) in their financial statements for financial periods beginning on or after 1 January 2005.

1.3.1 More about the Standards and their Interpretations

1.3.1.1 The standards

The idea of a single global accounting language is not new. It all started with the International Accounting Standards Committee (IASC) in 1973. Over the years, this committee developed 41 global accounting standards, referred to as International Accounting Standards (IAS). This committee was then replaced by the International Accounting Standards Board (IASB), established in 2001. This new board adopted all 41 IASs and started the development of more global accounting standards. So far, the newly created IASB has developed 8 new standards, referred to as the International Financial Reporting Standards (IFRSs).
We now, therefore, have a total of 49 global accounting standards (IFRS):

- 41 of which are referenced as IAS 1 – 41 (produced by the old committee) and
- 8 of which are referenced as IFRS 1 – 8 (produced by the new board).

1.3.1.2 The interpretations of the standards

Many global accounting standards have had to be interpreted. These interpretations are developed when accountants and auditors notify the board of difficulties in understanding and applying certain parts of a standard. These interpretations were previously developed by a committee called the Standing Interpretations Committee (SIC). This committee developed 34 interpretations (SIC 1 – SIC 34), only 11 of which still stand, with the rest having been gradually withdrawn as a result of the harmonisation process. The interpretations are now developed by a committee of the new IASB, called the International Financial Reporting Interpretations Committee (IFRIC). To date, 14 new interpretations have been developed by the IFRIC (IFRIC 1 – IFRIC 14).

1.3.1.3 How the standards and interpretations are developed

When these boards and committees develop the global accounting standards (a term that refers to both the standards and their interpretations), it requires members of the IASB and the IFRIC to consult with national standard-setters from all of the participating countries to ensure that all of their ideas have been considered. In considering which ideas or combination of ideas to adopt as the new standard, they use what is referred to as the Framework. This framework sets out the basic objectives, characteristics, concepts, definitions, recognition and measurement criteria relevant for a good set of financial statements.

In summary, the rules of our global accounting language consist of:

- The Framework and
- the global accounting standards (IFRS), including both the:
  - Standards (IASs and IFRSs); and their
  - Interpretations (SICs and IFRICs).

In time, it is expected that all standards will be renumbered and referred to as IFRSs and all interpretations will be renumbered and referred to as IFRICs. In the meantime, financial statements that are reported to comply with IFRSs are assumed to comply with all standards (IASs and IFRSs) and their interpretations (SICs and IFRICs).

A tabular summary of the above is as follows:

IFRS:	Previously produced by	Now produced by	Number of voting members per board/ committee
Standards →	IASC →	IASB →	14 members
Interpretations →	SIC →	IFRIC →	12 members

The IASC has been replaced by the IASB, but the IASC Foundation is the organisation upon which the IASB and the IFRIC are built. The structure of the team behind the preparation of the IFRS and IFRICs is presented below:

There are 22 trustees	**International Accounting Standards Committee Foundation (IASCF)**	22	*They appoint members to SAC, IASB and IFRIC; oversee the process and raise funds*
There are approx 40 members who meet three times a year. SAC operates in an advisory capacity to the IASCF and the IASB	**Standards Advisory Council (SAC)**	+- 40	*They prioritise the IASB's work, advise the IASB on their views on major standards projects and give other advice to both the IASB and the trustees*
There are 12 full-time and 2 part-time members. The IASB reports to the IASCF.	**International Accounting Standards Board (IASB)**	14	*Develop and pursue the technical agenda, issue interpretations, basis for conclusions with standards and exposure drafts. They need 9 votes out of 14 to get standards, exposure drafts and interpretations published*
The 12 members are unpaid but have expenses reimbursed. They meet every second month. The IFRIC reports to the IASB.	**International Financial Reporting Interpretations Committee (IFRIC)**	12	*They make interpretations and consider public comments and get final approval from IASB. Before applying for final approval from the IASB, the IFRIC need 9 votes out of 12*

1.4 The International Improvements Project

During the process of harmonisation, *new* ideas develop that result in changes having to be made to some of the existing standards and their interpretations. This is what is referred to as the *Improvements Project*.

1.5 Due process and transparency

Before a new standard is issued, an exposure draft is first issued. The exposure draft may only be issued after approval by at least nine of the fourteen members of the IASB and is issued together with:

- the opinions of those members of the IASB who did not approve of the exposure draft and
- the basis for the conclusions that were made by the rest of the IASB members.

Any interested party may comment on these drafts. The comments received are thoroughly investigated after which the draft is adopted as a new standard (either verbatim or with changes having been made for the comments received) or is re-issued as a revised exposure draft for further comment.

2. IFRS versus GAAP

2.1 Overview

The Statements of GAAP is short for: *Statements of Generally Accepted Accounting Practice*. These include the documented acceptable methods used by businesses to 'recognise, measure and disclose' business transactions. The best of these statements from all over the world are being merged into the IFRSs, which is short for *International Financial Reporting Standards*.

2.2 Compliance with IFRS

Legally, financial statements must generally comply with the national statutory requirements of the relevant country. The problem is that most statutes (laws) of many countries currently require compliance with either *generally accepted accounting practice* or the *statements of generally accepted accounting practice*. A strict interpretation of the requirement to comply with *generally accepted accounting practice* (GAAP) suggests that 'if everyone is doing it, so can we', or in other words, the official *Statements or Standards* need not be complied with.

In all cases, if a country wishes its business entities to use global accounting standards (IFRS), the terms included in that country's legislation will have to require compliance with *international financial reporting standards and the interpretations thereof (IFRS)* instead.

In addition to the requirements of the legal statute of the country, IAS 1 (Presentation of Financial Statements) requires that where companies do comply with *international financial reporting standards and the interpretations thereof* (in their entirety), disclosure of this fact must be made in their financial statements. By implication, those companies that do not comply, may not make such a declaration. It is obviously beneficial to be able to make such a declaration since it lends credibility to the financial statements, makes them understandable to foreigners and thus encourages investment.

3. The Pillars

This section (and the entire chapter) relates to what I call the 'pillars of accounting', a very important area, without which the 'top floor' of your knowledge cannot be built. The foundations of this 'building' were built in prior years of accounting study. If you feel that there may be cracks in your foundation, right now is the time to fix them by revising your work from prior years. Please read this chapter very carefully because every other chapter in this book will assume a thorough understanding thereof.

There are two areas of the global standards that make up these pillars:
- the Framework and
- IAS 1: Presentation of Financial Statements.

3.1 The Framework

The Framework is technically not a standard but the *foundation* for all standards and interpretations. It therefore does not override any of the IFRSs but should be referred to as the basic logic when interpreting and applying a difficult IFRS (the term IFRS includes the standards and the interpretations). It sets out the:
- objective of financial statements, that is to say, the information that each component of a set of financial statement should offer;
- underlying assumptions inherent in a set of financial statements;
- qualitative characteristics that the financial statements should have;
- elements in the financial statements (assets, liabilities, equity, income and expenses);
- recognition criteria that need to be met before the element may be recognised in the financial statements;
- measurement bases that may be used when measuring the elements; and
- concepts of capital and capital maintenance.

IFRSs are designed to be used by profit-orientated entities (commercial, industrial and business entities in either the public or private sector) when preparing general purpose financial statements (i.e. financial statements that are used by a wide variety of users).

3.2 IAS 1: Presentation of financial statements

IAS 1 builds onto the Framework and in some areas tends to overlap a little. IAS 1 has as its main objective 'comparability' and with this in mind, sets out:
- the purpose of financial statements;
- the general features of a set of financial statements;
- the structure and minimum content of the five main components of financial statements:
  - the statement of financial position (as at the end of the period);
  - the statement of comprehensive income (for the period);
  - the statement of changes in equity (for the period);
  - the statement of cash flows (for the period); and
  - the notes to the financial statements;
- other presentation issues, such as how to differentiate between items that are considered current and those that are considered non-current (necessary when drawing up the statement of financial position).

4. The Framework

4.1 The objectives of financial statements

The objective of financial statements is to provide information that is useful to a wide range of users regarding the entity's:

- financial position: found mainly in the statement of financial position;
- financial performance: found mainly in the statement of comprehensive income;
- changes in financial position: found mainly in the statement of changes in equity; and
- management's stewardship of the resources entrusted to it.

It is important to note that users are not limited to shareholders and governments, but include, amongst others, employees, lenders, suppliers, competitors, customers and the general public.

4.2 Underlying assumptions

The Framework lists two underlying assumptions:

- going concern; and
- accrual basis.

These are discussed in more depth under overall considerations (see Part 5: IAS 1 Presentation of Financial Statements).

4.3 Qualitative characteristics

In order for financial statements to be useful to its users, it must have certain qualitative characteristics or attributes. The four main qualities that a set of financial statements should have are listed as follows:

- understandability
- relevance
- reliability
- comparability.

Although one must try to achieve these qualitative characteristics, the Framework itself admits to the difficulty in trying to achieve a balance of characteristics. For example: to ensure that the information contained in a set of financial statements is relevant, one must ensure that it is published quickly. This emphasis on speed may, however, affect the reliability of the reports. This balancing act is the fifth attribute listed to in the Framework, and is referred to as *constraints on relevant and reliable information.*

If the four principal qualitative characteristics and the Standards are complied with, one should achieve fair presentation, which is the sixth and final attribute listed in the Framework.

4.3.1 Understandability

The financial statements must be *understandable* to the user but you may assume, in this regard, that the user has:

- a reasonable knowledge of accounting and
- a willingness to carefully study the financial information provided.

4.3.2 Relevance

When deciding what is *relevant,* one must consider the:

- users' needs in decision-making:
  A user will use financial statements to predict, for example, the future asset structure, profitability and liquidity of the business and to confirm his previous predictions. The predictive and confirmatory role of the financial statements is therefore very important to

consider when presenting financial statements. By way of example, unusual items should be displayed separately because these, by nature, are not expected to recur frequently;

- materiality of the items:
  Consider the materiality of the size of the item or the potential error in user-judgement if it were omitted or misstated;
- nature:
  For example, reporting a new segment may be relevant to users even if profits are not material.

Materiality is a term that you will encounter very often in your accounting studies and is thus important for you to understand. The Framework explains that you should consider something (an amount or some other information) to be material:

- if the economic decisions of the users
- could be influenced if it were misstated or omitted.

Materiality is considered to be a 'threshold' or 'cut-off point' to help in determining what would be useful to users and is therefore not a primary qualitative characteristic. For example, all revenue types above a certain amount may be considered to be material to an entity and thus the entity would disclose each revenue type separately.

4.3.3 Reliability

In order for financial statements to be reliable, they should not include material error or bias and should:

- be a faithful representation;
- show the substance rather than the legal form of the transaction;
- be neutral;
- be prudent (but not to the extent that reserves become hidden); and
- be complete (within the confines of materiality and cost).

4.3.3.1 Faithful representation

Most financial statements have some level of risk that not all transactions and events have been properly identified and that the measurement basis used for some of the more complex transactions might not be the most appropriate. Sometimes events or transactions can be so difficult to measure that the entity chooses not to include them in the financial statements. The most common example of this is the internal goodwill that the entity is probably creating but which it cannot recognise due to the inability to clearly identify it and the inability to measure it reliably.

4.3.3.2 Substance over form

This requires that the legal form of a transaction be ignored if the substance or economic reality thereof differs. A typical example here is a lease agreement (the legal document). The term 'lease' that is used in the legal document suggests that you are borrowing an asset in exchange for payments (rental) over a period of time. Many of these so-called lease agreements result in the lessee (the person 'borrowing' the asset) keeping the asset at the end of the 'rental' period. This means that the lease agreement is actually, in substance, not a lease but an agreement to purchase (the 'lessee' was actually purchasing the asset and not renting the asset). This lease is referred to as a finance lease, but as accountants, we will recognise the transaction as a purchase (and not as a pure lease).

4.3.3.3 Neutrality

For financial statements to be neutral, they must be free from bias. Bias is the selection or presentation of information in such a way that you achieve a 'pre-determined result or outcome' in order to influence the decisions of users.

4.3.3.4 Prudence

Applying prudence when drawing up financial statements means to be cautious if judgement is required when making estimates under conditions of uncertainty. The idea behind prudence is to:
- avoid overstating assets and income, and
- avoid understating liabilities and expenses,

but without :
- creating hidden reserves and excessive provisions, or
- deliberately understating assets and income, or
- overstating liabilities and expenses for reasons of bias.

4.3.3.5 Completeness

Financial statements need to be as complete as possible given the confines of materiality and cost. This is because omission of information could be misleading and result in information that is therefore unreliable and not relevant. Immaterial items may be excluded if too costly to include.

4.3.4 Comparability

Financial statements should be comparable:
- from one year to the next: therefore, accounting policies must be consistently applied, meaning that transactions of a similar nature should be treated in the same way that they were treated in the prior years; and
- from one entity to the next: therefore entities must all comply with the same standards, so that when comparing two entities a measure of comparability is guaranteed.

As a result of requiring comparability, users need to be provided with information for the comparative year and should be provided with the accounting policies used by the entity (and any changes that may have been made to the accounting policies used in a previous year).

4.3.5 Constraints to relevance and reliability

Although one must strive to achieve these qualitative characteristics, the Framework itself admits to at least two constraints encountered most often when trying to achieve relevance and reliability in a set of financial statements.

These constraints are essentially time and money:
- timeliness:
  - the financial statements need to be issued soon after year-end to be relevant, but this race against time leads to reduced reliability; and
- cost versus benefit:
  - to create financial statements that are perfect in terms of their relevance and reliability can lead to undue effort, with the result that this benefit is outweighed by the enormous cost to the entity; and a
- balance among the qualitative characteristics.

Bearing in mind that only fresh information is *relevant*, the 1999 financial statements of a business are not relevant to a user in 2008 who is trying to decide whether or not to invest in that business. The problem is, in the rush to produce relevant and timely financial statements, there is a greater risk that they now contain errors and omissions and are thus *unreliable*.

This balancing act is compounded by the constraint of *cost*. Money is obviously a constraint in all profit organisations whose basic idea is that the benefit to the business should outweigh the cost. To produce financial statements obviously costs the business money, but this cost increases the faster one tries to produce them (due to costs such as overtime) and the better one tries to do them (more time and better accountants cost more money). Businesses often find this a difficult pill to swallow because, on the face of it, it is the business that incurs these costs and yet it is the user who benefits. It should be remembered, however, that the benefits are often hidden. If the user or bank is suitably impressed by your financial statements, the business may benefit by more investment, higher share prices, lower interest rates on bank loans and more business partners, ventures and opportunities.

4.4 Elements

The five elements are as follows:
- asset;
- liability;
- equity;
- income; and
- expense

4.4.1 Asset

- a resource
- controlled by the entity
- as a result of past events
- from which future economic benefits are expected to flow to the entity.

4.4.2 Liability

- a present obligation *(not a future commitment!)*
- of the entity
- as a result of past events
- the settlement of which is expected to result in an outflow from the entity of economic benefits.

4.4.3 Equity

- the residual interest in the assets
- after deducting all liabilities.

4.4.4 Income

- an increase in economic benefits
- during the accounting period
- in the form of inflows or enhancements of assets or decreases in liabilities
- resulting in increases in equity (other than contributions from equity participants).

4.4.5 Expense

- a decrease in economic benefits
- during the accounting period
- in the form of outflows or depletions of assets or an increase in liabilities
- resulting in decreases in equity (other than distributions to equity participants).

4.5 Recognition

The term 'recognition' means the actual recording (journalising) of a transaction or event. Once recorded, the element will be included in the journals, trial balance and then in the financial statements.

An item may only be recognised when it:
- meets the relevant definitions (i.e. is an element as defined); and
- meets the recognition criteria.

The basic *recognition criteria* are as follows:
- the flow of future economic benefits caused by this element are *probable*; and
- the element has a cost/value that can be *reliably measured***.**

Assets or liabilities must meet the recognition criteria in full (must be measured reliably and the flow of benefits must be probable).

Income or expenses need not meet the recognition criteria in full: they only need to be measured reliably.

It is important to read the definition of income and expense again and grasp how these two elements may only be recognised when there is a change in the carrying amount of an asset or liability. This means that for an item of income or expense to be recognised, the definition of asset or liability would first need to be met.

4.6 Measurement

If an item meets the definition of an element and meets the necessary recognition criteria, we will need to process a journal entry. To do this, we need an amount. The term 'measurement' refers to the process of deciding or calculating the amount to use in this journal entry.

There are a number of different methods that may be used to measure the amounts of the individual elements recognised in the financial statements, some of which are listed below:
- The historical cost method
  - measures an asset at the actual amount paid for it at the time of the acquisition; and
  - measures the liability at the amount of cash (or other asset) received as a loan or at the actual amount to be paid to settle the obligation in the normal course of business.
- The present value method
  - measures an asset at the present value of the future cash inflows (i.e. discounted) to be derived from it through the normal course of business; and
  - measures liabilities at the present value of the future cash outflows (i.e. discounted) expected to be paid to settle the obligation during the normal course of business.
- The realisable value method
  - measures an asset at the cash amount for which it can be currently sold in an orderly disposal; and
  - measures liabilities at the actual amount of cash (undiscounted) that would be required to settle the liability during the normal course of business.
- The current cost method
  - measures an asset at the amount that would currently have to be paid if a similar asset were to be acquired today; and
  - measures liabilities at the actual amount of cash (undiscounted) that would be required to settle the liability today.

There are a variety of combinations of the above methods, many of which are largely dictated by the relevant standard. For instance, assets that are purchased with the intention of resale are measured in terms of *IAS 2: Inventories,* which states that inventories should be measured at the *lower* of cost or net realisable value. Assets that are purchased to be used over more than one period are measured in terms of *IAS 16: Property, Plant and Equipment,* which allows an asset to be recognised at either historical cost or fair value (determined in accordance with a discounted future cash flow technique: present value, or in terms of an active market: current cost). Redeemable debentures (a liability) are measured in terms of *IAS 39: Financial Instruments: Recognition and Measurement.*

Although most companies seem to still be measuring many of their assets at historical cost, there appears to be a definite interest in fair value accounting, where present values and current costs are considered more appropriate than historical cost. There is an argument that says that the historical cost basis should be abandoned and replaced by fair value accounting since the generally rising costs caused by inflation results in the historical amount paid for an item having no relevance to its current worth. A problem with fair value accounting, however, is its potentially subjective and volatile measurements which could reduce the reliability of the financial statements. The possibility of reduced reliability could be the reason why most companies still use historical costs for many of their assets, where the latest fair values are disclosed in their notes for those users who are interested.

4.7 When the element is not recognised

Items that do not meet the relevant definitions and recognition criteria in full may not be recognised in the financial statements. Information about this item may, however, still be considered to be 'relevant' to the user, in which case it should be *disclosed* in the notes.

4.8 Recognition versus disclosure

As mentioned earlier, the term '*recognition*' means the actual recording (journalising) of a transaction or event. Once recorded, the element will be included in the journals, trial balance and then channelled into one of the financial statements: statement of comprehensive income, statement of changes in equity or statement of financial position (all presented on the accrual basis), as well as the statement of cash flows (a financial statement presented on the cash basis).

The term 'disclosure' means giving *detail* about specific transactions or events that are either:
- already recognised in the financial statements; or
- not recognised in the financial statements but yet are considered material enough to affect possible economic decisions made by the users of the financial statements.

Some items that are *recognised* may require further disclosure. Where this disclosure involves a lot of detail, this is normally given in the notes to the financial statements.

Other items that are *recognised* may not need to be *disclosed*. For example, the purchase of a computer would be recorded in the source documents, journals, trial balance and finally in the statement of financial position. Unless this computer was particularly unusual, it would be included in the total of the non-current assets on the face of the statement of financial position, but would not be separately disclosed anywhere in the financial statements since it would not be relevant to the user when making his economic decisions.

Conversely, some items that are *not recognised* may need to be *disclosed*. This happens where either the definition or recognition criteria (or both) are not met, but yet the information is still expected to be relevant to users in making their economic decisions. A typical example is a law suit against the entity which has not been recognised because the financial impact on the entity has not been able to be reliably estimated but which is considered to be information critical to a user in making his economic decisions.

4.9 Answering discussion type questions

When answering a discussion type question involving the recognition of the elements, it is generally advisable to structure your answer as follows:
- quote the definition of the relevant element/s and discuss each aspect of it with reference to the transaction in order to ascertain whether or not the definition/s is met;
- quote the relevant recognition criteria and then discuss whether the element meets each of the recognition criteria; and
- conclude by stating which element the item should be classified as (based on the definition) and then whether or not this element should be recognised at all (based on the recognition criteria).

The structure of your answer depends entirely on the wording of the question. If the question asks for you to discuss the *recognition* of an element, it may require the word for word repetition of both the definitions and recognition criteria unless your question specifically tells you not to give these, in which case, just the discussion is required. Generally each aspect of the definition and recognition criteria should be discussed fully (use your mark allocation as a guide) but some questions may not require a full discussion but may require you to identify what element should be recognised and to support this with only a brief explanation.

The question may ask you to *prove* that the debit or credit entry is a certain element (e.g. a liability), in which case it is generally fine to simply discuss the definition and recognition criteria relevant to that element (i.e. the liability). In other cases, you may be required to *discuss* which element the debit or credit entry represents, in which case you are generally required to discuss both the asset and expense definitions if it is a debit entry, or the liability, income and perhaps even the equity definitions if it is a credit entry.

Your question may ask for a discussion of the issues surrounding measurement, in which case calculations of the amounts may also be required. If you are only asked to discuss the measurement of an amount, then do not discuss the recognition issues (i.e. do not discuss the definitions and recognition criteria – you will be wasting valuable time).

4.10 Some examples

Example 1: benefits earned over more than one period – expense or asset?

A machine is purchased for C4 000 in cash. The machine was delivered on the same day as the payment was made. It is expected to be used over a 4-year period to make widgets that will be sold profitably. At the end of the 4-year period, the asset will be scrapped.

Required:
Discuss how the purchase of the machine should be recognised and measured. The definitions and recognition criteria are not required.

Solution to example 1: benefits earned over more than one period – expense or asset?

Definition:
- A machine is a resource since it can be used to make widgets.
- The machine has been delivered (and been paid for) and is thus controlled by the entity.
- An inflow of future economic benefits is expected through the sale of the widgets.
- The past event is the payment of the purchase price/ delivery of the machine.

Since all aspects of the definition of an asset are met, the item (the machine) is an asset to the entity.

Recognition criteria:
- The cost is reliably measured: C4 000 already paid in full and final settlement.
- The inflow of future economic benefits is probable since there is no evidence that the widgets will not be produced and sold.

Conclusion:
Since both recognition criteria are met, the asset should be recognised.

	Debit	Credit
Machine: cost (A)	4 000	
Bank (A)		4 000
Purchase of machine		

PS. If you were also asked to briefly prove that the initial acquisition did not involve an expense, then you should provide the following discussion as well:
Since the entity's assets simultaneously increased (through the addition of a machine) and decreased (through the outflow of cash), there has been no effect on equity and therefore no expense.

Measurement:
The measurement on initial recognition is the invoice price (i.e. historical cost basis), but the future asset balances in the statement of financial position must reflect the state of the asset. As the machine's life is used up in the manufacturing process, so the remaining future economic benefits (expected

through its future use) will decrease. Since this decrease in the asset's value occurs with no simultaneous increase in assets or decrease in liabilities, the equity of the business will be decreased. The amount by which the asset's value is reduced is therefore recognised as an expense.

	Debit	Credit
Journal in year 1, 2, 3 and 4		
Depreciation: machine (E)	xxx	
Machine: accumulated depreciation (negative A)		xxx
Depreciation of machine		

The portion of the asset's value that is recognised as an expense each year is measured on a systematic rational basis over the 4-year period:

- If the widgets are expected to be manufactured and sold evenly over the 4-year period, then C1 000 should be expensed in each of these 4 years (C4 000 / 4 years).
- If 50% of the widgets are expected to be manufactured and sold in the first year, 30% in the second year and 10% in each of the remaining years, then a more rational and systematic basis of apportioning the expense over the 4 years would be as follows:
  - Year 1: C4 000 x 50% = 2 000
  - Year 2: C4 000 x 30% = 1 200
  - Year 3: C4 000 x 10% = 400
  - Year 4: C4 000 x 10% = 400

Example 2: an inflow – income or liability?

A gym receives a lumpsum payment of C4 000 from a new member for the purchase of a 4-year membership.

Required:
Briefly discuss whether the lumpsum received should be recognised as income or a liability. The definitions of both income and liability should be discussed (ignore recognition criteria).

Solution to example 2: an inflow – income or liability?

Liability definition:

- The entity has an obligation to provide the member with gym facilities over the next 4 years
- The past event is the entity's receipt of the C4 000.
- The obligation will result in an outflow of cash, for items such as salaries for the gym instructors, electricity and rental of the gym facilities.

Since all aspects of the liability definition are met, the receipt represents a liability.

Income definition:

- The initial lumpsum represents an increase in cash (an increase in assets)
- There is, however, an increase in liabilities since the club is now expected to provide the member with gym facilities for the next 4 years which effectively means that the gym has an equal and opposite obligation (an increase in its liabilities).
- For there to be income, there must be an increase in equity: since the increase in the asset equals the increase in the liability, there is no increase in equity (equity = assets – liabilities).

Since there is no increase in equity the receipt does not represent income – yet.

Conclusion:
At the time of the receipt, the lumpsum is recognised as a liability and journalised as follows:

	Debit	Credit
Bank (A)	4 000	
Income received in advance (L)		4 000
Gym fees received as a lumpsum in advance		

PS. Had you not been asked to only discuss the initial lumpsum received, you could then have given the following discussion as well:
As time progresses, the gym will discharge its obligation thus reducing the liability. The amount by which the liability reduces is then released to income since it meets the definition of income:

For example, after each year of providing gym facilities there is an inflow of economic benefits through the decrease in the liability: the obligation to provide 4 years of gym facilities, drops to 3 years, then 2 years, 1 more year and finally the obligation is reduced to zero.

In this way, the receipt is recognised as income on a systematic basis over the 4 years during which the the entity will incur the cost of providing these services (i.e. the income is effectively matched with the expenses incurred over 4-years). In each of the 4 years during which the gym provides facilities to the member, the following journal will be processed (after processing 4 of these journals, there will be no balance on the liability account and the entire C4 000 received will have been recognised as income).

	Debit	Credit
Income received in advance (L)	1 000	
Membership fees (I)		1 000
Portion of the lumpsum recognised as income		

Example 3: staff costs – an asset?

Companies often maintain that their staff members constitute their biggest asset. However, the line-item 'people' is never seen under 'assets' in the statement of financial position.

Required:
Explain why staff members are not recognised as assets in the statement of financial position.

Solution to example 3: staff costs – an asset?

In order for 'staff' to appear in the statement of financial position as an asset, both the following need to be satisfied:
- the definition of an asset; and
- the recognition criteria.

First consider whether a 'staff member' meets the *definition of an 'asset'*.
- *Is the staff member a resource?*
  A staff member is a resource – a company would not pay a staff member a salary unless he/ she were regarded as a resource. In fact, employees are generally referred to as '*human resources'*.
- *Is he controlled by the entity?*
  Whether or not the staff member is controlled by the entity is highly questionable: it is considered that, despite the existence of an employment contract, there would always be insufficient control due to the very nature of humans.
- *Is the staff member a result of a past event?*
  The signing of the employment contract could be argued to be the past event.
- *Are future economic benefits expected to flow to the entity as a result of the staff member?*
  It can be assumed that the entity would only employ persons who are expected to produce future economic benefits for the company.

In respect of the asset, the *recognition criteria* require that
- the flow of future economic benefits to the entity must be *probable***;** AND
- the asset has a cost/value that can be *reliably measured***.**

It is *probable* that future economic benefits will flow to the entity otherwise the entity would not employ the staff.

The problem arises when one tries to *reliably measure* the cost/value of each staff member. How would one value one staff member over another? Perhaps one could calculate the present value of their future salaries, but there are two reasons why this is unacceptable. Consider the following:
- Can you reliably measure the *cost* of a staff member? If one were to use future expected salaries and other related costs, consider the number of variables that would need to be estimated: the period that the staff member will remain in the employ of the entity, the inflation rate over the expected employment period, the fluctuation of the currency, the future performance of the staff

member and related promotions and bonuses. You will surely then agree that a *reliable* measure of their cost is really not possible.

- Since it is evident that we cannot reliably measure the cost of a staff member, can one reliably measure their *value* in another way? The value of a staff member to an entity refers to the value that he or she will bring to the entity in the future. It goes without saying that there would be absolutely no way of assessing this value *reliably*!

Staff members may therefore not be recognised as assets in the statement of financial position for two main reasons:
- there is insufficient control over humans; and
- it is not possible to reliably measure their cost or value.

5. IAS 1: Presentation of financial statements: an overview

5.1 Overview

IAS 1 was revised in September 2007. The main changes are as follows:
- the names of the components of a set of financial statements have been changed;
    - income statement is now: statement of comprehensive income;
    - balance sheet is now: statement of financial position;
    - cash flow statement is now: statement of cash flows;
- the introduction of a statement of comprehensive income, which incorporates the 'old income statement' followed by 'other comprehensive income', the latter being previously included in the statement of changes in equity;
- a simplified statement of changes in equity showing only transactions involving owners in their capacity as owners, where transactions that comprise 'non-owner changes in equity' (which were previously included) are now included in the statement of comprehensive income as 'other comprehensive income';
- other changes in terminology:
    - equity holders are now called: owners
    - balance sheet date is now called: end of the reporting period
    - overall considerations are now called: general features
- the introduction of an eighth general feature: frequency of reporting.

The main reasons given by the IASB for revising IAS 1 included:
- an intention to aggregate financial information on the basis of shared characteristics, thus:
    - changes in equity that *are due* to transactions with owners in their capacity as owners are included in the statement of changes in equity; whereas
    - changes in equity that *are not due* to transactions with owners in their capacity as owners are included in the statement of comprehensive income;
- convergence with the USA's *FASB Statement No. 130Reporting Comprehensive Income*;
- making IAS 1 easier to read.

5.2 Scope (IAS 1.2 to IAS 1.6)

IAS 1 applies to profit-orientated entities in preparing and presenting general purpose financial statements. It therefore is *not designe*d to meet the needs of non-profit entities.

It is also *not designed* to meet the needs of condensed interim financial statements, although five of the eight general features in IAS 1 should be applied to interim financial statements:
- fair presentation and compliance with IFRSs
- going concern
- accrual basis of accounting
- materiality and aggregation
- offsetting.

IAS 1 is designed for entities whose share capital is equity. If an entity does not have such equity, the presentation of owners' interests would need to be adapted.

5.3 Objective of IAS 1 (IAS 1.1)

The objective of IAS 1 is to prescribe how to (i.e. the basis on which to) present financial statements in order to achieve comparability (a qualitative characteristic listed in the Framework):
- With the entity's own financial statements for different periods; and
- With other entity's financial statements.

5.4 Objective of financial statements (IAS 1.9 and the Framework)

Here is a perfect example of the overlapping between the Framework and IAS1: both include the objective of financial statements. Financial statements are designed to be a
- structured representation of an entity's financial position, financial performance and cash flows
- that is useful to a wide range of users in making economic decisions; and
- showing the results of management's stewardship of the resources entrusted to it.

5.5 Definitions (IAS 1.7)

The following definitions are provided in IAS 1 (some of these definitions are simplified):

General purpose financial statements (referred to as '**financial statements**'):
are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

Impracticable:
Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

International Financial Reporting Standards (referred to as **IFRSs**):
are Standards and Interpretations adopted by the IASB (they include the following prefixes: IFRSs, IASs and IFRIC interpretations and SIC interpretations).

Materiality of omissions and misstatements of items:
Omissions and misstatements are material if they could individually or collectively influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Notes:
- provide narrative descriptions or disaggregations of items presented in the other financial statements (e.g. statement of financial position); and
- provide information about items that did not qualify for recognition in those other financial statements.

Profit or loss:
- is the total of income less expenses,
- excluding the components of other comprehensive income.

Other comprehensive income:
- Comprises items of income and expense (including reclassification adjustments)
- That are either not required or not permitted to be recognised in profit or loss.
- The components of other comprehensive income include:

(a) Changes in revaluation surplus (IAS 16 *Property, plant and equipment* and IAS 38 *Intangible assets*);
(b) Actuarial gains and losses on defined benefit plans (being those recognised in accordance with paragraph 93A of IAS 19 *Employee Benefits);*
(c) Gains and losses arising from translating the financial statements of a foreign operation (IAS 21 *The effects of changes in foreign exchange rates*);
(d) Gains and losses on remeasuring available-for-sale financial assets (IAS 39 *Financial instruments: recognition and measurement*);
(e) The effective portion of gains and losses on hedging instruments in a cash flow hedge (IAS 39 *Financial instruments: recognition and measurement*).

Total comprehensive income:
- Is the change in equity
- during a period
- resulting from transactions and other events,
- other than those changes resulting from transactions with owners in their capacity as owners.
- Total comprehensive income = 'profit or loss' + 'other comprehensive income'.

5.6 Complete set of financial statements (IAS 1.10)

There are five *main* statements in a complete set of financial statements:
- the statement of financial position (as at the end of the period);
- the statement of comprehensive income (for the period);
- the statement of changes in equity (for the period);
- the statement of cash flows (for the period); and
- the notes to the financial statements;

The statement of comprehensive income may be provided either as:
- a single statement: statement of comprehensive income; or
- two separate statements: an income statement (also referred to as a statement of profit or loss), followed by a statement of comprehensive income.

The general features, structure and content of these statements are now discussed in detail.

6. IAS 1: Presentation of financial statements: general features

6.1 Overview

IAS 1 lists eight general features to consider when producing financial statements (notice that this list includes two of the underlying assumptions included in the Framework):
- fair presentation and compliance with IFRS;
- going concern (also an underlying assumption per the Framework);
- accrual basis (also an underlying assumption per the Framework);
- materiality and aggregation;
- offsetting;
- frequency of reporting;
- comparative information; and
- consistency of presentation.

6.2 Fair presentation and compliance with IFRSs (IAS 1.15-24)

6.2.1 Achieving fair presentation (IAS 1.15 and IAS 1.17)

Fair presentation simply means that position, performance and cash flows must be recorded faithfully (truthfully).

Fair presentation will generally always be achieved if the transactions, events and conditions are recorded by:

- complying with the definitions and recognition criteria provided in the Framework,
- complying with all aspects of the IFRSs; and
- providing extra disclosure where necessary.

In order to ensure that fair presentation is achieved, the standard emphasises that one must:

- select and apply accounting policies in accordance with *IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors*;
- present all information in a manner that provides relevant, reliable, comparable and understandable information (P.S. these are the qualitative characteristics per the *Framework*); and
- provide additional disclosure when the relevant standards are unable to provide the user with sufficient understanding of the impact of certain transactions, events and conditions on the financial position and performance of the entity.

6.2.2 Compliance with IFRSs (IAS 1.16 and IAS 1.24)

Where all aspects of the IFRS have been complied with, disclosure of this fact must be made in the financial statements. This disclosure may only be made if *absolutely all* the IFRSs (standards and interpretations) have been complied with in full.

6.2.3 Departure from IFRSs (IAS 1.16 and IAS 1.24)

In extremely rare circumstances, management may believe that by applying an IFRS the financial statements become misleading, so much so that the objective of financial statements is undermined. In order to come to such a dramatic conclusion, management must consider:

- why the objective of financial statements is not achieved in the entity's particular circumstances; and
- how the entity's circumstances differ from those of other entities that have successfully complied with the IFRS's requirement/s.

The obvious answer to this problem is to depart from the IFRS, but this is not always allowed.

6.2.3.1 When departure from an IFRS is required and allowed (IAS 1.19-22)

An entity shall depart from an IFRS:

- if compliance with the IFRS would result in financial statements that are so misleading that they 'would conflict with the objective of financial statements set out in the Framework', ***and***
- if the relevant regulatory framework requires or does not prohibit such departure in this situation,

The extra disclosure required when there has been departure from an IFRS is as follows:

- management's conclusion that the financial statements 'fairly present the entity's financial position, financial performance and cash flows';
- a declaration to the effect that the entity has complied with applicable standards and interpretations of IFRS except that it has departed from a particular standard or interpretation in order to achieve fair presentation;
- the name of the standard (or interpretation) from which there has been departure;
- the nature of the departure, including the treatment that is required by the standard;
- the reason why it was considered to be so misleading;
- the treatment adopted; and
- the financial impact of the departure on each item that would otherwise have had to be reported had the IFRS been properly complied with.

The same disclosure (with the exception of management's conclusion and the declaration referred to above) would be required every year after the departure where that departure continues to affect the measurement of amounts recognised in the financial statements.

6.2.3.2 When departure from an IFRS is required but not allowed (IAS 1.23)

When departure from IFRS is considered necessary for fair presentation but yet is disallowed by the relevant regulatory framework, the financial statements will be misleading. Since the objective of financial statements is basically to provide useful information, the lack of fair presentation must be remedied through disclosure of the following:

- the name of the IFRS that is believed to have resulted in misleading information;
- the nature of the specific requirement in the IFRS that has led to misleading information;
- management's reasons for believing that the IFRS has resulted in financial statements that are so misleading that they do not meet the objectives of financial statements; and
- the adjustments that management believes *should* be made in order to achieve faithful representation.

6.3 Going concern (IAS 1.25-26)

6.3.1 Financial statement preparation (IAS 1.25)

Financial statements should be prepared on the going concern basis unless management:

- voluntarily or
- involuntarily (i.e. where there is no realistic alternative) plans to:
  - liquidate the entity; or
  - simply cease trading.

6.3.2 Management's responsibility (IAS 1.25-26)

Management is required to make an assessment of the entity's ability to continue as a going concern.
This assessment should:

- be made while the financial statements are being prepared;
- be based on all available information regarding the future (e.g. budgeted profits, debt repayment schedules and access to alternative sources of financing); and
- include a review of the available information relating to, at the very least, one year from statement of financial position date.

Such a detailed analysis is not required, however, if the entity has a history of profitable operations and ready access to funds.

6.3.3 If there is significant doubt that the going concern basis is appropriate (IAS 1.25)

If cessation or liquidation is not imminent, but there is significant doubt as to the ability of the entity to continue operating, the material uncertainties causing this doubt must be disclosed.

6.3.4 If the going concern basis is not appropriate (IAS 1.25)

If the entity is not considered to be a going concern, the financial statements must not be prepared on the going concern basis, and disclosure must include:

- this fact;
- the basis used to prepare the financial statements (e.g. the use of liquidation values); and
- the reason why the entity is not considered to be a going concern.

6.4 Accrual basis of accounting (IAS 1.27-28)

The accrual basis of accounting means recording elements (assets, liabilities, income, expenses and equity) when the definitions and recognition criteria are met. It results in recognising transactions and events in the periods in which they occur rather than when cash is received or paid.

The accrual basis is applied to all components of a set of financial statements, with the exception of statement of cash flows, which obviously uses the cash basis instead.

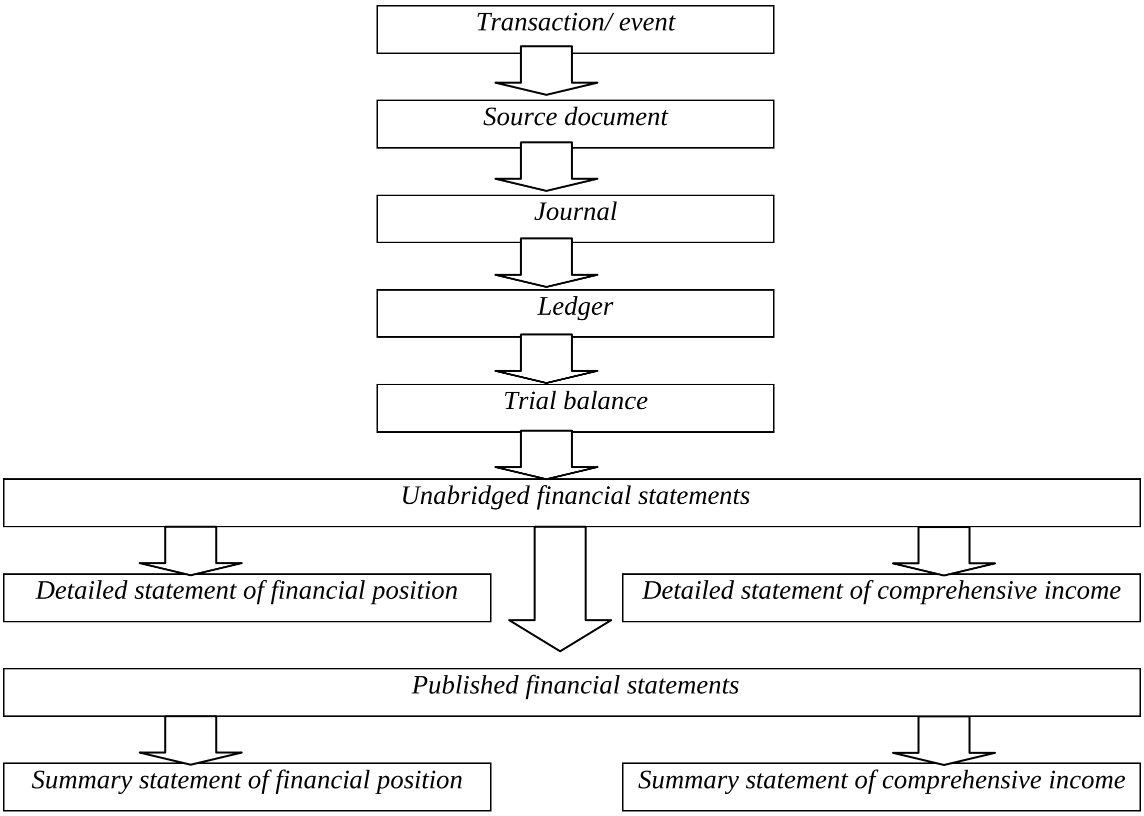
6.5 Materiality and aggregation (IAS 1.29-31)

6.5.1 Accountancy involves a process of logical summarisation

Simply speaking, the financial process starts with:

- a transaction that is first documented (onto a source document);
- the document is then journalised (in subsidiary journals);
- the journal is then posted (into the subsidiary and general ledger);
- the ledger is summarised into the trial balance;
- the trial balance is summarised into the detailed set of financial statements – a summary used by internal users (e.g. management); and
- these financial statements are then further summarised into what is referred to as the *published* set of annual financial statements.

The published annual financial statements do not show extensive detail because they are made available to a wide range of external users who would find that too much information would be confusing and irrelevant to their decision-making. It is interesting to note that it is only these published financial statements that are subjected to the disclosure requirements laid out in the IFRS.



6.5.2 Deciding whether an item is material and needs to be segregated (IAS 1.29-31)

Each *class* of items that is material should be separately disclosed (segregated). Where a *class* of items is immaterial, it must be aggregated (included) with another class of items. IAS 1 refers to a *class* of items as having a bearing on the *nature or function* of the items.

Materiality is a term that you will encounter very often in your accounting studies and is thus important for you to understand. Both the *Framework* and *IAS 1* explain that you should consider something to be material if the economic decisions of the users could be influenced if it were misstated or omitted. It is a threshold or cut-off point used to help identify whether something may be useful to a user. For example, an entity may have a materiality threshold for revenue of C100 000, with the result that any revenue types that exceed C100 000 will be separately disclosed.

A class of items that is very material may require disclosure separately on the *face* of the financial statements whereas another class of items, although material, may only require separate disclosure in the *notes*. It is a subjective decision requiring professional judgement.

So in summary, when considering whether to segregate (present separately) or aggregate an item (present as part of another total), consider its class, (being its nature or function) and if you think that knowledge of it:

- *would affect* the economic decisions of the user, then the item is material and should be disclosed separately (i.e. should be segregated); or
- *would not affect* the economic decisions of the user, then the item is not material and should *not* be disclosed separately (i.e. should be aggregated).

It is generally not considered necessary for an item to be material in nature, function and size before it should be separately disclosed, but logic should prevail.

Example 4: items with different functions

Explain whether or not the following classes should be separately disclosed: :

- inventory; and
- property, plant and equipment.

Solution to example 4: items with different functions

The function of inventory is to be sold at a profit whereas the function of property, plant and equipment is to be kept and used by the entity. The functions of these two assets are considered to be so different that they are considered sufficiently material to be disclosed separately on the face of the statement of financial position.

Example 5: items with different natures, but immaterial size

The total carrying amount of furniture is C100 000, and the total carrying amount of land is C50 000. The company's materiality limit is C300 000.

Required:
Explain whether or not the furniture and land should be disclosed as two separate categories.

Solution to example 5: items with different natures, but immaterial size

Although the carrying amount of each class is below the materiality limit, the two classes would be disclosed separately (generally only in the notes) since although the assets may be argued to be similar in the sense that both are assets to be used in the business, the difference in function or nature of each is material enough for the amount spent on each to be relevant to the economic decisions of the user.

Example 6: items that are material in size, but not in nature or function

A company's materiality limit is C300 000 and the total carrying amount of its:
- machinery is C500 000, including machine A, with a carrying amount of C450 000;
- office furniture is C300 000; and
- office equipment is C310 000.

Required:
Explain whether or not:
- machine A should be separately disclosed from other machinery based on size; and
- furniture and office equipment should be disclosed as two separate categories based on the size of the carrying amounts of each category relative to the materiality limit.

Solution to example 6: items that are material in size, but not in nature or function

Machine A and the other machinery:
Despite the fact that machine A is material in *size*, machine A should not be separately disclosed since, with reference to most user's needs, this is not material in *function or nature* (a separate description of machine A would be information more of a technical than a financial nature and would thus mean very little to *most* general users).

Furniture and office equipment:
Similarly, despite the materiality of the individual *sizes* of the carrying amounts involved, office furniture and office equipment could be aggregated due to their common *function or nature*: office use.

Although office furniture and machinery represent two dissimilar classes on the basis that their functions are so diverse, furniture and machinery should be aggregated on the face of the statement of financial position because, at this overall level of presentation, the class of asset becomes immaterial. What is more important on the face of the statement of financial position is that different categories of assets, such as property, plant and equipment versus inventory are separated. The detail of the material classes within the categories of property, plant and equipment and inventory are included in the notes. It should be noted, that where functions are materially different but amounts are immaterial, it may still be necessary to disclose separately in the notes, being a matter of judgement, once again.

6.5.3 What to do with immaterial items (IAS 1.30-31)

Immaterial items are aggregated with other items. For instance, each and every item of furniture would not be listed separately in the statement of financial position, but would be *aggregated* with all other items of furniture since they are similar in nature and it is not *material* to the user to know the value of each individual chair, table and lamp at year-end. Instead, it would be more useful to the user to simply know the total spent on furniture.

6.6 Offsetting (IAS 1.32-35)

There should be no offsetting of:
- income and expenses; or
- assets and liabilities

unless it:
- reflects the substance of the transaction; and
- is either allowed or required in terms of the related standard or interpretation.

An example of the *allowed* off-setting of income and expenses would be in the calculation of the profit or loss on sale of a non-current asset. The proceeds of the sale (income) may be set off against the carrying amount of the asset (now expensed) together with any selling expenses, with the result that the substance of the transaction is reflected.

An example of the setting off of income and expenses that is *not allowed* is revenue from a sale and the related cost of the sale since revenue is required, in terms of the relevant standard (IAS 18: Revenue), to be disclosed separately.

An example of when offsetting is *required* is *IAS 16: Property, Plant and Equipment*, where the cost of acquiring an asset must be reduced by the proceeds earned through the incidental sale of any item that may have been produced while bringing the asset to a useful location and condition (e.g. the sale of samples made when testing the asset before bringing it into use).

Example 7: sale of a machine (set-off is allowed)

During 20X2, a machine (a non-current asset) with a carrying amount of C20 000 is sold for C30 000.

Required:
Disclose the above transaction in the statement of comprehensive income.

Solution to example 7: sale of a machine (set-off is allowed)

Company name
Statement of comprehensive income
For the year ended ….. (extracts)

	Calculations	**20X2** **C**
Other income		
- Profit on sale of machine	*30 000 – 20 000*	10 000

Explanation: Since the sale of the machine is considered to be incidental to the main revenue generation of the business, the income may be disclosed *net* of the expense.

Example 8: sale of a machine (set-off is not allowed)

A company, whose business is to buy and sell machines, sold a machine for C30 000 (original cost of the machine was C20 000) during 20X2.

Required:
Disclose the above transaction in the statement of comprehensive income.

Solution to example 8: sale of a machine (set-off is not allowed)

Company name
Statement of comprehensive income
For the year ended ….. (extracts)

	20X2 **C**
Revenue	30 000
Cost of sales	20 000

Explanation: since the sale of the machine is considered to be part of the main revenue generation of the business, the disclosure of the income is governed by *IAS 18: Revenue* and must therefore be shown gross (i.e. not shown net of the expense).

Example 9: cost of a machine (set-off is required)

An entity bought a machine on 31 December 20X2 that it intended to keep for 10 years. It cost C30 000. Before the machine could be brought into use, it had to be tested: this cost C5 000. During the testing process, 1 000 widgets were produced, which were all sold immediately at C1 each. IAS 16 (paragraph 17) requires that the cost of the asset be calculated after deducting net proceeds from selling any items produced when testing.
Required:
Disclose the machine in the statement of financial position as at 31 December 20X2. This is the only item of property, plant and equipment owned by the entity.

Solution to example 9: cost of a machine (set-off is required)

Company name
Statement of financial position
As at 31 December 20X2 (extracts)

	Calculations	20X2 C
Property, plant and equipment	*30 000 + 5 000 – 1 000 x C1*	34 000

6.7 Frequency of reporting (IAS 1.36-37)

Entities are required to produce financial statements at least annually. Some entities prefer, for practical reasons, to report on a 52-week period rather than a 365-day period. This is fine!

Sometimes, however, an entity may change its year-end, with the result that the reporting period is either longer or shorter than a year. The entity must then disclose:
- The reason for the longer or shorter period; and
- The fact that the current year figures are not entirely comparable with prior periods.

It is interesting to note that amounts in the current year's statement of position would still be entirely comparable with the prior year's statement because a statement of position is merely a listing of values on a specific day rather than over a period of time. On the other hand, the amounts in the current year's statement of comprehensive income would not be comparable with the prior year's statement since the amounts in each year reflect different periods.

6.8 Comparative information (IAS 1.38-44)

6.8.1 When there has been no change in presentation (IAS 1.38-39; 41-42)

For all statements making up the complete set of financial statements, a minimum of one year of comparative figures is required (i.e. this means that there would be two statements of financial position: one for the current year and one for the prior year). This requirement for comparative information applies equally to both numerical and narrative information.

With regard to narrative information, however, prior year narrative information need not be given if it will not enhance the understanding of the current period's financial statements. An example: information as to how a court case was resolved in the *prior* year would no longer be relevant to the *current* year financial statements.

Conversely, narrative information that *was* provided in the prior year may *need* to be followed up with narrative information in the current year, if it will enhance the usefulness of the financial statements. An example: when the *prior* year financial statements included information regarding an *un*resolved court case, details regarding how this court case was resolved during the *current* year or the status of the dispute at the end of the current year (if the case is still not yet resolved) would enhance the usefulness of the financial statements and should therefore be disclosed.

6.8.2 When there has been a change in presentation (IAS 1.41-44 and IAS 1.39)

A change in presentation occurs if there is a retrospective change in accounting policy, restatement of prior year figures when correcting an error or a reclassification of items. In order to ensure comparability from one year to the next, when the current year presentation differs from that in the prior year, the comparative information must be reclassified.

If there has been such a change in presentation in the current year,

- the prior period information should be adjusted accordingly;
- the following additional disclosures are required:
  - the nature of the reclassification
  - the amount of the items affected;
  - the reason for reclassification; and
- an additional statement of financial position is required showing the balances at the beginning of the earliest comparative period (i.e. it now needs *two* sets of comparatives).

If the recalculation of the prior period's figures based on the new approach is impracticable,

- the following must be disclosed instead:
  - the reason for not reclassifying; and
  - the nature of the changes that would have been made had the figures been reclassified.

Example 10: reclassification of assets

An entity's nature of business changed in 20X3 such that *vehicles* that were previously held for use became stock-in-trade (i.e. inventory). The unadjusted property, plant and equipment balances are as follows:

- 20X2: C100 000 (C60 000 being machinery and C40 000 being vehicles)
- 20X3: C150 000 (C80 000 being machinery and C70 000 being vehicles).

Required:
Disclose the assets in the statement of financial position and notes as at 31 December 20X3.

Solution to example 10: reclassification of assets

Entity name
Statement of financial position
As at 31 December 20X3 (EXTRACTS)

	Notes	**20X3** **C**	**20X2** **C** **Restated**
Property, plant and equipment	*8*	80 000	60 000
Inventory	*8*	70 000	40 000

Entity name
Notes to the financial statements
For the year ended 31 December 20X3 (EXTRACTS)

8. Reclassification of assets

Previously inventory was classified as part of property, plant and equipment whereas it is now classified separately. The reason for the change in the classification is that the nature of the business changed such that vehicles previously held for use are now held for trade. *IAS 2: Inventories* requires inventories to be classified separately on the face of the statement of financial position. The amount of the item that has been reclassified is as follows:

	20X3 **C**	**20X2** **C**
• Inventory	70 000	40 000

6.9 Consistency of presentation (IAS 1.45-46)

The presentation and classification of items should be the same from one period to the next unless:

- there is a significant change in the nature of the operations; or
- the current financial statement presentation is simply not the most appropriate; or
- a change in presentation is required as a result of an IFRS;

and

- the revised presentation and classification is likely to continue; and
- the revised presentation and classification is reliable and more relevant to users.

If the presentation in the current year changes, then the comparative information must be adjusted with relevant disclosures (see comparative information above).

7 IAS 1: Presentation of financial statements: structure and content

7.1 The financial report (IAS 1.49-50)

A financial report is published at least annually. Included in this annual report are

- the financial statements (including five main statements); and
- a variety of other statements and reports, which may or may not be required.

The purpose of financial statements is to provide information regarding financial position, financial performance and cash flows that are useful in the economic decision-making of a wide range of users. They are also intended to be an account of management's stewardship of the resources entrusted to it (a report on how management looked after the entity's net assets).

Since the IFRSs only apply to the financial statements, it is important that any other statements and reports are separately identified and not confused with the financial statements.

7.1.1 The financial statements

There are five main statements in a set of financial statements, all governed by IFRS:

- statement of financial position;
- statement of comprehensive income;
- statement of changes in equity;
- statement of cash flows; and the
- notes to the financial statements.

7.1.2 Other statements and reports

Other statements and reports are often included in the financial report. These could be included voluntarily, as a result of other legislative requirements or included as a response to community concerns (e.g. environmental reports might be included to satisfy current public concerns regarding global warming). Other examples include:

- an index (no financial statements come without this!);
- directors' report;
- audit report
- environmental report (not compulsory but yet is encouraged);
- value-added statement (not compulsory but yet is encouraged); and a
- variety of other reports that may be compulsory or advisable for fair presentation.

7.2 Identification issues (IAS 1.51-53)

The financial statements, being governed by the IFRS, must be clearly identified from the rest of the annual report, since the rest of the report is not governed by the IFRS.

For obvious reasons, each statement (e.g. statement of comprehensive income) in the financial statements needs to be clearly identified.

Other items may need to be prominently displayed and repeated where necessary (e.g. on the top of each page) where it affords a better understanding of the financial information. Examples of these other items include:
- the name of the entity (and full disclosure of any change from a previous name);
- the fact that the financial statements apply to an individual entity or a group of entities;
- relevant dates: date of the end of the reporting period for the statement of financial position or the period covered for other statements (e.g. statement of cash flows);
- presentation currency (e.g. pounds, dollars, rands); and the
- level of rounding used (i.e. figures in a column that are rounded to the nearest thousand, such as C100 000 shown as C100, should be headed up *'C'000'*).

7.3 The statement of financial position

7.3.1 Overview

The statement of financial position gives information regarding the entity's financial position. There were no prizes for guessing that one!

The Framework explains that the position of the entity is represented by:
- economic resources controlled by the entity;
- financial structure;
- liquidity; and
- solvency.

The statement of financial position summarises the trial balance into the three main elements:
- assets;
- liabilities; and
- equity.

These three elements are then categorised under two headings:
- assets; and
- equity and liabilities.

The assets and liabilities are then generally separated into two further categories:
- current; and
- non-current.

7.3.2 Current versus non-current (IAS 1.60-65)

Assets and liabilities must be separated into the basic categories of current and non-current, unless simply listing them in order of liquidity gives reliable and more relevant information.

No matter whether your statement of financial position separates the assets and liabilities into the categories of current and non-current or simply lists them in order of liquidity, if the item includes both a portion that:
- is current (i.e. will be realised (settled) *within* 12 months after the reporting date); and that
- is non-current (i.e. will be realised (or settled) *later than* 12 months after reporting date),

the non-current portion must be separately disclosed *somewhere* in the financial statements. This may be done in the notes rather than in the statement of financial position.

Where the assets and liabilities are *monetary* assets or liabilities (i.e. financial assets or liabilities) disclosure must be made of their maturity dates. An example of a monetary asset is an investment in a fixed deposit. An example of a monetary liability is a lease liability.

Where the assets and liabilities are *non-monetary* assets or liabilities, disclosure of the maturity dates is not required but is encouraged since these dates would still be useful in assessing liquidity and solvency. For instance, inventory (a non-monetary asset) that is not expected to be sold within a year should be separately identified in the notes with an indication as to when it might be sold. Land is another example of a non-monetary asset. A provision is an example of a non-monetary liability.

7.3.3 Assets (IAS 1.66-68 and IAS 1.70)

7.3.3.1 Current assets versus non-current assets

Current assets are assets:
- that are expected to be realised within 12 months after the reporting period;
- that are expected to be sold, used or realised (converted into cash) as part of the normal operating cycle (where the 'operating cycle' is the period between purchasing assets and converting them into cash or a cash equivalent);
- that are held mainly for the purpose of being traded; or
- that are cash and cash equivalents - so long as they are not restricted in their use within the 12 month period after the reporting period. For example, a cash amount received by way of donation, a condition to which is that it must not be spent until 31 December 20X5 may not be classified as a current asset until 31 December 20X4 (12 months before).

Non-current assets are simply defined as those assets that:
- are not current assets.

It is interesting to note that assets that are part of the normal operating cycle (for example: inventories and trade receivables) would always be considered to be current and do not need to be realised, sold or used within 12 months after the reporting period.

Marketable securities (e.g. an investment in shares) are not considered to be part of the operating cycle (since they are not integral to the fundamental operations of the business) and therefore need to be realised within 12 months from reporting date to be considered current.

7.3.4 Liabilities (IAS 1.69-76)

7.3.4.1 Current liabilities versus non-current liabilities (IAS 1.69-71)

Current liabilities are liabilities:
- that are expected to be settled within 12 months after the reporting period;
- the settlement of which are expected within the normal operating cycle (operating cycle: the period between purchasing materials and converting them into cash/ cash equivalent);
- that are held mainly for trading purposes; or
- the settlement of which the entity does not have an unconditional right to defer for at least 12 months after the reporting period.

Non-current liabilities are simply defined as those liabilities that:
- are not current liabilities.

It is interesting to note that liabilities that are considered to be part of the normal operating cycle (e.g. trade payables and the accrual of wages) would always be treated as current liabilities since they are integral to the main business operations – even if payment is expected to be made more than 12 months after the reporting period.

Examples of liabilities that are not part of the normal operating cycle include dividends payable, income taxes, bank overdrafts and other interest bearing liabilities. For these liabilities to be classified as current liabilities, settlement thereof must be expected within 12 months after the reporting period.

Example 11: classification of liabilities

An entity has two liabilities at 31 December 20X3:

- a bank loan of C500 000, payable in annual instalments of C100 000 (the first instalment is payable on or before 31 December 20X4); and
- the electricity account of C40 000, payable immediately.

Required:
Disclose the liabilities in the statement of financial position and notes at 31 December 20X3 assuming that the entity discloses its assets and liabilities:
A In order of liquidity
B Under the headings of current and non-current.
Ignore comparatives.

Solution to example 11A: liabilities in order of liquidity

Entity name
Statement of financial position
As at 31 December 20X3 (EXTRACTS)

	Notes	**20X3**
		C
Bank loan	8	500 000
Accounts payable		40 000

Entity name
Notes to the financial statements
For the year ended 31 December 20X3 (extracts)

	20X3
8. Bank loan	**C**
Total loan	500 000
Portion repayable within 12 months	100 000
Portion repayable after 12 months	400 000

The bank loan is expected to be settled in 5 annual instalment of C100 000, the first of which is due to be paid on or before 31 December 20X4. Interest is charged at xx%.

Solution to example 11B: liabilities using current and non-current

Entity name
Statement of financial position
As at 31 December 20X3 (extracts)

	Notes	**20X3**
Non-current liabilities		**C**
Bank loan	8	400 000
Current liabilities		
Current portion of bank loan	8	100 000
Accounts payable		40 000

Entity name
Notes to the financial statements
For the year ended 31 December 20X3 (extracts)

	20X3
8. Bank loan	**C**
Total loan	500 000
Portion repayable within 12 months	100 000
Portion repayable after 12 months	400 000

The bank loan is expected to be settled in 5 annual instalment of C100 000, the first of which is due to be paid on or before 31 December 20X4. Interest is charged at xx%.

7.3.4.2 Refinancing of financial liabilities (IAS 1.71-73 and IAS 1.76)

Refinancing a financial liability means to postpone the due date for repayment. When a liability that was once *non-current* (e.g. a 5-year bank loan) falls due for repayment *within* 12 months after reporting period, it needs to be reclassified as *current*. If it was possible to refinance this liability resulting in the repayment being delayed *beyond* 12 months after the end of the reporting period, then the liability could remain classified as *non-current*.

There are, however, only two instances where the possibility of refinancing may be used to avoid having to classify a financial liability as a current liability:

- where an agreement is obtained that allows repayment of the loan to be delayed beyond the 12-month period after the reporting period;
  - where the original term of the loan was for a period of more than 12 months (i.e. the liability started its life as a non-current liability), and
  - the agreement is signed *before the reporting date*; (where this agreement is only signed *after the reporting date* but *before approval* of the financial statements, this would be a 'non-adjusting post-reporting period event' and could not be used as a reason to continue classifying the liability as non-current); and
- where the *existing* loan agreement includes an option to refinance or roll-over the obligation (i.e. to delay repayment of) where:
  - the option enables a delay until at least 12 months after the reporting period, and
  - the option is at the discretion of the entity (as opposed to the bank, for example), and
  - the entity intends to refinance or roll over the obligation.

Example 12: liabilities and refinancing of due payments

A loan of C100 000 is raised in 20X1. This loan is to be repaid in 2 instalments as follows:

- C40 000 in 20X5; and
- C60 000 in 20X6.

An agreement is reached, whereby the payment of the C40 000 need only be made in 20X6.

Required:

Show the statement of financial position at 31 December 20X4 (year-end) assuming that:

A the agreement is signed on 5 January 20X5;

B the agreement is signed on 27 December 20X4.

Solution to example 12A: loan liability not refinanced in time

Entity name
Statement of financial position
As at 31 December 20X4

	20X4	**20X3**
LIABILITIES AND EQUITY	**C**	**C**
Non-current liabilities	60 000	100 000
Current liabilities	40 000	-

Note: although the liability has to be separated into a current and non-current portion, note disclosure should be included to explain that the current liability of C40 000, is now a non-current liability due to the signing of a refinancing agreement during the post-reporting period.

Solution to example 12B: loan liability is refinanced in time

Entity name
Statement of financial position
As at 31 December 20X4

	20X4	**20X3**
LIABILITIES AND EQUITY	**C**	**C**
Non-current liabilities	100 000	100 000

Example 13: refinancing of a loan

Needy Limited has a loan of C600 000, payable in 3 equal annual instalments. The first instalment is due to be repaid on 30 June 20X4.

Required:
Disclose the loan in the statement of financial position of Needy Limited as at 31 December 20X3 (year-end) assuming that the existing loan agreement:

A provides the entity with the option to refinance the first instalment for a further 7 months and the entity plans to utilise this facility;
B provides the entity with the option to refinance the first instalment for a further 4 months and the entity plans to utilise this facility
C provides the entity with the option to refinance the first instalment for a further 7 months but the entity does not plan to postpone the first instalment
D provides the bank with the option to allow the first instalment to be delayed for 7 months.

Solution to example 13: refinancing of a loan

Entity name
Statement of financial position
As at 31 December 20X4

	(A)	**(B)**	**(C)**	**(D)**
	20X3	**20X3**	**20X3**	**20X3**
LIABILITIES AND EQUITY	**C**	**C**	**C**	**C**
Non-current liabilities	600 000	400 000	400 000	400 000
Current liabilities	0	200 000	200 000	200 000

Note: under scenario B, the extra 4 months only extends the repayment to 31 October 20X4 and not beyond 31 December 20X4.

7.3.4.3 Breach of covenants and the effect on liabilities (IAS 1.74-76)

Covenants (other terms you could use: provisions/ undertakings / promises made by the borrower to the lender) are sometimes included in the loan agreement. If a covenant is breached (broken), the lender may be entitled to demand repayment of a portion of the loan – or even the entire amount thereof.

Therefore, if there has been a breach of such a covenant (e.g. the borrower promises to keep the current ratio above 2:1 but then allows the current ratio to drop below 2:1), that portion of the liability that can be recalled (i.e. the portion that the lender may demand repayment of) should automatically be disclosed as current unless:

- the lender agrees *prior to the end of the reporting period* to grant a period of grace to allow the entity to rectify the breach;
- the period of grace lasts for at least 12 months after the reporting period; and
- the lender may not demand immediate repayment during this period.

If such an agreement is signed after the end of the reporting period but before the financial statements are authorised for issue, this information would be disclosed in the notes but the liability would have to remain classified as current.

Example 14: breach of covenants

Whiny Limited has a loan of C500 000, repayable in 20X9. The loan agreement includes the following condition: if widget units sold by 31 December of any one year drops below 12 000, then 40% of loan becomes payable immediately. At 31 December 20X3 unit sales were 9 200.

The company reached an agreement with the bank such that they were granted a grace period.

Required:
Disclose the loan in the statement of financial position as at 31/12/20X3 assuming that the agreement was signed on:

A 31 December 20X3, giving the entity a 14-month period of grace during which the bank agreed not to demand repayment;
B 31 December 20X3, giving the entity a 14-month period of grace (although the bank reserved the right to revoke this grace period at any time during this period and demand repayment);
C 31 December 20X3, giving the entity a period of grace to 31 January 20X4 during which the bank agreed not to demand repayment. At 31 January 20X4, the breach had been rectified;
D 2 January 20X4, giving the entity a 14-month period of grace during which the bank agreed not to demand repayment.

Solution to example 14: breach of covenants

Entity name **Statement of financial position** **As at 31 December 20X3**	**(A)**	**(B)**	**(C)**	**(D)**
LIABILITIES AND EQUITY	**20X3** **C**	**20X3** **C**	**20X3** **C**	**20X3** **C**
Non-current liabilities	500 000	300 000	300 000	300 000
Current liabilities	0	200 000	200 000	200 000

Note: in scenario C, a note should be included to say that a period of grace was given and that the breach was rectified after the end of the reporting period.
In scenario D, a note should be included to say that a period of grace had been granted after the end of the reporting period that provided a grace period of more than 12 months from reporting date.

7.3.5 Disclosure: in the statement of financial position (IAS 1.54-55)

According to IAS 1, the following items must be disclosed in the statement of financial position in order to meet the minimum disclosure requirements:

- property, plant and equipment;
- investment property;
- intangible assets;
- financial assets;

- investments accounted for using the equity method (this is a financial asset but one that requires separate disclosure);
- biological assets (e.g. sheep);
- inventories;
- trade and other receivables (a financial asset but one that requires separate disclosure);
- cash and cash equivalents (a financial asset but one that requires disclosure separate to the other financial assets);
- financial liabilities;
- trade and other payables (a financial liability but one that requires separate disclosure);
- provisions (a financial liability but one that requires separate disclosure);
- tax liabilities (or assets) for current tax;
- deferred tax liabilities (or assets);
- assets (including assets held within disposal groups held for sale) that are held for sale in terms of *IFRS 5 Non-current Assets Held for Sale;*
- liabilities that are included in disposal groups classified as held for sale in terms of *IFRS 5 Non-current Assets Held for Sale;*
- minority interests (presented within equity);
- issued capital and reserves attributable to equity holders of the parent; and
- any additional line-items, headings and sub-totals considered to be relevant to the understanding of the entity's position.

Whether or not to disclose additional *line items* on the face of the statement of financial position requires an assessment of the following:

- Assets: the liquidity, nature and function of assets; examples include:
    - cash in bank is separated from a 6-month fixed deposit since the liquidity differs;
    - property, plant and equipment is shown separately from intangible assets since their nature differs (tangible versus intangible);
    - inventory is shown separately from intangible assets since their functions differ (buy to sell versus buy to use).
- Liabilities: the amounts, timing and nature of liabilities; examples include:
    - C100 000 of a C500 000 long-term loan is repayable within 12 months of reporting date, thus requiring C100 000 to be disclosed separately as a current liability and C400 000 as non-current (based on the timing of the liability);
    - provisions are shown separately from tax payable since their natures differ.

7.3.6 Disclosure: either in the statement of financial position or notes (IAS 1.77-80)

7.3.6.1 Sub-classifications (IAS 1.77-78)

The line items in the statement of financial position may be broken down further into sub-classifications.

These sub-classifications may be shown either as:

- a line item in the statement of financial position; or
- in the notes.

The *sub-classifications* to be provided depend on:

- the disclosure requirements of the IFRSs:
    - Example: *IAS 16 Property, Plant and Equipment* requires that the total be broken down into the different classes of land, buildings, plant, machinery, vehicles etc;
- the materiality of the amounts, liquidity, nature and function of assets:
    - Example: inventory that is slow-moving should be separately shown from inventory that is expected to sell within a normal period of time since their liquidity is different;
    - Example: trade and other accounts receivable should be broken-down into trade accounts receivable, expenses prepaid and other amounts receivable since their natures are different;
    - Example: office equipment should be separately shown from factory equipment because their functions differ (administrative versus manufacturing);
    -

- the materiality of the amounts, timing and nature of liabilities:
  - Example: trade and other accounts payable should be broken-down into trade accounts payable and other amounts payable since their natures are different;
  - Example: a bank overdraft that is payable on demand should be shown separately from a short-term loan that is payable within 2 months since the timing of the payments differ.

7.3.6.2 Extra detail (IAS 1.79-80)

IAS 1 requires extra detail to be disclosed regarding two items that are included in the statement of financial position:
- share capital; and
- reserves.

Disclosure of the required extra detail may be provided:
- in the statement of financial position; or
- in the statement of changes in equity; or
- in the notes.

It is generally, however, a good idea to keep the face of the statement as simple and uncluttered as possible, disclosing as much as possible in the notes.

For each class of share capital, the extra detail that must be disclosed includes:
- the number of shares authorised;
- the number of shares issued and fully paid for;
- the number of shares issued but not yet fully paid for;
- the par value per share or that they have no par value;
- a reconciliation of the number of outstanding shares at the beginning and end of the year;
- rights, preferences and restrictions attaching to that class;
- shares in the entity held by the entity itself, or its subsidiaries or its associates; and
- shares reserved for issue under options and sales contracts, including terms and amounts.

In a situation where an entity has no share capital, (e.g. a partnership), disclosure that is equal to the above should be made regarding each category of equity interest instead.

For each reserve within equity, the extra detail that must be disclosed includes:
- its nature; and
- its purpose.

7.3.7 A typical statement of financial position

7.3.7.1 Overview

The following are examples of what a statement of financial position might look like. The line items needed for your entity might be fewer or more than those shown in these examples: it depends entirely on what line-items are relevant to your entity (e.g. if an entity does not have goodwill, then this line-item will not appear on its statement).

Remember that if the 'liquidity format' provides more meaningful disclosure for your entity than the 'current : non-current' classification, then the statement of financial position will look just the same but without the headings 'current' and 'non-current'.

The total equity on the statement of financial position is equal to the total equity on the statement of changes in equity. If you are required to present both a statement of financial position and a statement of changes in equity, then *good exam technique* would be to start with the statement of changes in equity and then, when preparing your statement of financial position, put the total equity per your statement of changes in equity in as 'issued shares and reserves'. There is nothing stopping you from listing the types of equity on the statement of financial position, except that it is not necessary and wastes valuable exam time!

7.3.7.2 Sample statement of financial position of a simplified, single entity

This is an example of a statement of financial position that might apply to a single entity. The statement of financial position of this single entity has been further simplified to show a very basic situation where, for example, the entity does not have investments of any kind and does not have non-current assets held for disposal.

ABC Ltd
Statement of financial position
As at 31 December 20X2

	20X2 C'000's	20X1 C'000's
ASSETS	**X**	**X**
Non-current assets	**X**	**X**
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
Current assets	**X**	**X**
Inventories	X	X
Trade and other receivables	X	X
Cash and cash equivalents	X	X
EQUITY AND LIABILITIES	**X**	**X**
Issued share capital and reserves	**X**	**X**
Non-current liabilities	**X**	**X**
Long-term borrowings	X	X
Deferred tax	X	X
Provisions	X	X
Current liabilities	**X**	**X**
Trade and other payables	X	X
Current portion of long-term borrowings	X	X
Short-term borrowings	X	X
Current tax payable	X	X

7.3.7.3 Sample statement of financial position of a group of entities

This is an example of a statement of financial position that might apply to a group of entities. You will notice that where a statement of financial position shows a group of entities, the total equity has to be broken down into the portion that belongs to the minority interest group and the portion that belongs to the owners of the parent company. This example includes more line-items than the previous simplified example: it now includes a variety of investments as well as non-current assets held for sale.

ABC Ltd
Consolidated statement of financial position
As at 31 December 20X2

	20X2 C'000's	20X1 C'000's
ASSETS	**X**	**X**
Non-current assets	**X**	**X**
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
Investment properties	X	X
Investments in associates	X	X
Available-for-sale investments	X	X
Non-current assets held for disposal	**X**	**X**
Current assets	**X**	**X**
Inventories	X	X
Trade and other receivables	X	X
Cash and cash equivalents	X	X
EQUITY AND LIABILITIES	**X**	**X**
Total equity (issue capital and reserves)	**X**	**X**
- belonging to shareholders of the parent company	X	X
- belonging to the minority shareholders	X	X
Non-current liabilities	**X**	**X**
Long-term borrowings	X	X
Deferred tax	X	X
Provisions	X	X
Current liabilities	**X**	**X**
Trade and other payables	X	X
Current portion of long-term borrowings	X	X
Short-term borrowings	X	X
Current tax payable	X	X
Current provisions	X	X

7.4 The statement of comprehensive income (IAS 1.81-105)

7.4.1 Overview (IAS 1.81; 1.84; i.88; 1.99 and 1.104)

The statement of comprehensive income gives information regarding the financial performance of the entity.

Comprehensive income basically includes two parts:
- profit or loss (income and expenses); and
- other comprehensive income (income and expenses that are not required or not permitted to be recognised in profit or loss).

7.4.2 Profit or loss (IAS 1.88 and 1.91)

Profit or loss includes items that are recognised as income and expense. The net of the income and expenses results in either a profit or loss.

This profit or loss is then included in total comprehensive income.

7.4.3 Other comprehensive income (IAS 1.88 and 1.90-91)

Other comprehensive income includes items of income and expense that were either not required or were not permitted to be included in profit or loss. There are five components to other comprehensive income (as defined):
- changes in a revaluation surplus;
- actuarial gains and losses on defined benefit plans*;*
- gains and losses arising from translating the financial statements of a foreign operation;
- gains and losses on re-measuring available-for-sale financial assets;
- the effective portion of gains and losses on hedging instruments in a cash flow hedge.

The total of these five components is then included in total comprehensive income.

These components may be shown in the statement of comprehensive income either:
- net of tax; or
- before tax, followed by one aggregate amount for the tax effect of all five components.

The amount of tax for each of the five components must be disclosed. This can be given either in the statement of comprehensive income or in the notes.

7.4.4 Expenses (IAS 1.99)

7.4.4.1 Overview

An analysis of the expenses must be provided based on either the
- nature of the expenses (nature method); or
- function of the expenses (function method).

Choosing between the 'nature' and 'function' methods depends on which method provides reliable and more relevant information. Exactly the same profits (or losses) will result no matter which method is used.

This analysis could be included in the statement of comprehensive income or in the notes.

The nature method is intended for a smaller, less sophisticated entity. The function method is designed for larger businesses that have the ability to allocate expenses to their functions on a reasonable basis. The function method actually requires that expenses be shown in both ways since:
- the classification by function is given in the statement of comprehensive income; and
- the classification by nature is given in the notes.

7.4.4.2 Function method (i.e. use or purpose) (IAS 1.103)

Generally, the four main functions (tasks) of a business include the sales, distribution, administration and other operations. If one uses the function method, one has to allocate the expenses incurred to these different functions. The function method is therefore more comprehensive than the nature method. It provides information that is more relevant, but there is a risk that arbitrary allocations may lead to less reliable information.

The 'function method' gives more relevant information to the user than the 'nature method': for instance it is possible to calculate the gross profit percentage using the function method, yet it isn't possible if the nature method is used.

Information relating to the nature of expenses is crucial information to those users attempting to predict future cash flows, therefore, if the function method is used, information regarding the nature of the expense (e.g. depreciation and staff costs) is also given, but this additional classification would have to be provided by way of a note.

An example showing the statement of comprehensive income using the *function method* follows. The highlighted section is the part of the statement of comprehensive income that changes depending on whether the 'function' or 'nature' method is used.

ABC Ltd
Statement of comprehensive income
For the year ended 31 December 20X2 (function method)

	20X2
	C
Revenue	X
Other income	X
Cost of sales	(X)
Distribution costs	(X)
Administration costs	(X)
Other costs	(X)
Finance costs	(X)
Profit before tax	X
Tax expense	(X)
Profit for the period	X
Other comprehensive income	X
Total comprehensive income	X

7.4.4.3 Nature method (IAS 1.102)

Using this method, expenses are disclosed according to their nature and are *not reallocated* amongst the various functions within the entity, for example depreciation, purchases of raw materials, transport costs, wages and salaries are all shown separately and are not allocated to cost of sales, distribution, administration and other operations. This method suits small businesses because of its simplicity.

An example of the layout using the *nature method* appears next. The highlighted portion shows the part of the statement of comprehensive income that changes depending on whether the 'function' or 'nature' method is used.

ABC Ltd
Statement of comprehensive income
For the year ended 31 December 20X2 (nature method)

	20X2
	C
Revenue	X
Other income	X
Add/ (Less) Changes in inventories of finished goods and work-in-progress	(X)
Raw materials and consumables used	(X)
Employee benefit costs	(X)
Depreciation	(X)
Other expenses	(X)
Total expenses	(X)
Finance costs	(X)
Profit before tax	X
Tax expense	(X)
Profit for the period	X
Other comprehensive income	X
Total comprehensive income	X

7.4.5 One statement or two statements (IAS 1.81 and 1.88)

There are two alternative layouts for a statement of comprehensive income:

- one statement:
  - a statement of comprehensive income (this is the old income statement followed on immediately by components of other comprehensive income); or
- two statements:
  - a statement of profit and loss (this can be called an income statement if you prefer); and
  - a statement of comprehensive income (this would start with the total profit or loss and then include items of income and expenses that were either not required or not permitted to be recognised in profit or loss).

Example 15: statement of comprehensive income: two layouts compared

The following is an extract of the trial balance of Apple Limited at year-end.

Trial Balance at 31 December 20X1	**Debit**	**Credit**
Revenue		1 000 000
Cost of sales	450 000	
Cost of distribution	120 000	
Cost of administration	80 000	
Interest expense	100 000	
Tax expense	70 000	

Other comprehensive income included one item:

- C170 000 on the revaluation of a machine (net of tax).

Required:

Prepare the statement of comprehensive income for the year ended 31 December 20X1 assuming:

A Apple Limited uses the single-statement layout;

B Apple Limited uses the two-statement layout.

Solution to example 15A: statement of comprehensive income: single statement

Apple Limited
Statement of comprehensive income
For the year ended 31 December 20X1

	20X1	**20X0**
	C	**C**
Revenue	1 000 000	X
Cost of sales	(450 000)	(X)
Distribution costs	(120 000)	(X)
Administration costs	(80 000)	(X)
Finance costs	(100 000)	(X)
Profit before tax	250 000	X
Tax expense	(70 000)	(X)
Profit for the year	180 000	X
Other comprehensive income, net of tax:		
Revaluation surplus increase	170 000	(X)
Total comprehensive income	350 000	X

Solution to example 15B: statement of comprehensive income: two statements

Apple Limited
Income statement
For the year ended 31 December 20X1

	20X1	**20X0**
	C	**C**
Revenue	1 000 000	X
Cost of sales	(450 000)	(X)
Distribution costs	(120 000)	(X)
Administration costs	(80 000)	(X)
Finance costs	(100 000)	(X)
Profit before tax	250 000	X
Tax expense	(70 000)	(X)
Profit for the year	180 000	X

Apple Limited
Statement of comprehensive income
For the year ended 31 December 20X1

	20X1	**20X0**
	C	**C**
Profit for the year	180 000	X
Other comprehensive income, net of tax:		
Revaluation surplus increase	170 000	(X)
Total comprehensive income	350 000	X

7.4.6 Reclassification adjustments (1.92-96)

It may be necessary to recognise a gain or loss in *profit or loss* where this gain or loss was previously included in *other comprehensive income*.

This can occur with the following three components of other comprehensive income:
- gains and losses arising from translating the financial statements of a foreign operation;
- gains and losses on re-measuring available-for-sale financial assets;
- the effective portion of gains and losses on hedging instruments in a cash flow hedge.

These adjustments do not apply to the other two components of other comprehensive income:
- changes in a revaluation surplus;
- actuarial gains and losses on defined benefit plans.

Changes in revaluation surplus and actuarial gains and losses are recognised directly in retained earnings and never through profit and loss.

It is important that any reclassification adjustment is:
- included with the related component of other comprehensive income
- in the same period that it is reclassified as part of profit or loss.

This must happen in the same period to avoid double-counting the gain (or loss) in income.

The adjustment may either be reflected in:
- the statement of comprehensive income; or
- the notes.

Example 16: statement of comprehensive income: reclassification adjustments

Banana Limited has financial assets that it has classified as available-for-sale. Available-for-sale financial assets are measured at fair value at the end of each year, with changes in fair value taken to equity (gain on available-for-sale assets account). When the assets are sold, any gain or loss is then realised and recognised as income. All the assets were:
- purchased on 1 June 20X1: for C100 000

- measured at 31 December 20X1 (the year-end): at their fair value of C120 000
- sold on 31 December 20X1: for C130 000.

The following was extracted before any journals related to these assets had been processed:

Trial balance (extracts)	Debit	Credit
Revenue		1 000 000
Cost of sales	450 000	
Cost of distribution	120 000	
Cost of administration	80 000	
Interest expense	100 000	
Tax expense	70 000	

Required:

A Show all the journal entries relating to the financial assets (ignore tax);

B Present the statement of comprehensive income (as a single statement), with reclassification adjustments provided in this statement (not in the notes). Ignore tax.

Solution to example 16A: journals

		Debit	Credit
1 June 20X1			
Financial assets	Given	100 000	
Bank			100 000
Purchase of financial assets			
31 December 20X1			
Financial assets		20 000	
Gain on available-for-sale assets (equity)			20 000
Measurement of financial asset – gain recognised as other comprehensive income (equity)			
Bank		130 000	
Financial assets			120 000
Profit on sale of financial assets (income)			10 000
Profit on sale of financial assets			
Gain on available-for-sale assets (equity)		20 000	
Profit on sale of financial assets (income)			20 000
Recognition of previous gain on financial asset (equity) as income			

Solution to example 16B: statement of comprehensive income

Banana Limited
Statement of comprehensive income
For the year ended 31 December 20X1

		20X1 C	20X0 C
Revenue		1 000 000	X
Cost of sales		(450 000)	(X)
Gross profit		550 000	X
Other income: profit on sale of financial assets	*(20 000 + 10 000)*	30 000	X
Distribution costs		(120 000)	(X)
Administration costs		(80 000)	(X)
Finance costs		(100 000)	(X)
Profit before tax		280 000	X
Tax expense		(70 000)	(X)
Profit for the year		210 000	X
Other comprehensive income:			
Gain on available-for-sale financial asset		0	X
Gains arising during the year		20 000	
Less reclassification adjustment: gain now included in profit and loss		(20 000)	
Total comprehensive income		210 000	X

7.4.7 Changes to profit or loss (IAS 1.89)

IAS 8 states that there are two instances where changes to profit or loss should not be recognised in the profit or loss for the current period but should be made retrospectively.

These two instances include:
- a change in accounting policy; and a
- a correction of a material prior period error.

Any changes due to these changes will be reflected in the statement of changes in equity and should not appear in the statement of comprehensive income.

7.4.8 Disclosure: in the statement of comprehensive income (IAS 1.82-87)

7.4.8.1 Disclosure: total comprehensive income

Certain items (where applicable to the entity) in the calculation of total comprehensive income must be disclosed as line items in the statement of comprehensive income:
- revenue *;
- finance costs *;
- share of profits and losses of equity-accounted associates and joint ventures *;
- tax expense *;
- in respect of discontinued operations, a total of the after-tax *:
  - profits or losses on the discontinued operation/s; and
  - gains or losses on the discontinued operation's assets caused by:
    - the measurement to fair value less costs to sell; or
    - the disposal of these assets or groups of assets ;
- profit or loss *;
- each component of other comprehensive income (classified by nature);
- share of other comprehensive income of equity-accounted associates and joint ventures;
- total comprehensive income.

Each item above that has been marked with the asterisk (*) would be included in the statement of profit or loss if the 'two-statement approach' was used.

Further disclosure is required of any additional line item that is considered to be relevant to the understanding of the entity's financial performance.

No item may be classified as extraordinary.

7.4.8.2 Disclosure: allocations of total comprehensive income

If an entity is part of a group where it is wholly owned by another company (the parent company), then 100% of the total comprehensive income would belong to this parent company. If, however, this parent company does not own 100% of the entity, but only a part thereof, then only that portion of the total comprehensive income would belong to the parent and the balance would belong to 'the other owners' (minority interests).

Where the comprehensive income is shared between a parent company and other minority owners, then the allocation between these two categories of owners must be disclosed in the statement of comprehensive income:
- the portion of the profit or loss that is attributable to the *:
  - owners of the parent;
  - minority interest; and
- the portion of total comprehensive income that is attributable to the:
  - owners of the parent;
  - minority interest.

*: the allocation of profit or loss can be given in the statement of profit or loss where this has been provided as a separate statement (i.e. if a two-statement approach had been used).

7.4.9 Disclosure: either in the statement of comprehensive income or the notes

In addition to disclosing the aggregate 'profit or loss' as a separate line item on the face of the statement of comprehensive income, certain of the income and expenses making up this amount may be material enough to require separate disclosure (either as separate line items in the statement of comprehensive income or in the notes), in which case their nature and amount must be disclosed. Examples of some material items (given in IAS 1) include:

- write-downs of assets and reversals thereof;
- restructuring costs and the reversal of provisions for costs of restructuring;
- disposals of property, plant and equipment and investments;
- discontinued operations;
- income and expenses relating to litigation settlements; and
- reversals of any other provisions

7.4.10 A typical statement of comprehensive income

7.4.10.1 Sample statement of comprehensive income for a simplified, single entity

This is an example of a statement of comprehensive income that might apply to a *single* entity. It has also been simplified to show a very basic statement where there are no associates or discontinued operations.

Please remember that the line items in your statement of comprehensive income might be fewer or more than those shown below. It depends entirely on what line-items are relevant to the entity (e.g. if the entity does not have available-for-sale assets, then one of the components of other comprehensive income would fall away).

ABC Ltd
Statement of comprehensive income
For the year ended 31 December 20X2 (function method)

	20X2	**20X1**
	C	**C**
Revenue	X	X
Other income	X	X
Cost of sales	(X)	(X)
Distribution costs	(X)	(X)
Administration costs	(X)	(X)
Other costs	(X)	(X)
Finance costs	(X)	(X)
Profit (or loss) before tax	X	X
Taxation	(X)	(X)
Profit (or loss) for the year	X	X
Other comprehensive income	X	X
• Gain on available-for-sale financial assets	X	X
• Increase in revaluation surplus	X	X
Total comprehensive income	X	X

7.4.10.2 Sample statement of comprehensive income for a group of entities

This example relates to a *group* of entities. When there is a group of entities, there needs to be a section that allocates profit and total comprehensive income between the:
- owners of the parent; and
- minority interests.

This example also includes more line-items that the first simplified example of a statement of comprehensive income: it now includes an associate and a discontinued operation.

ABC Ltd
Consolidated statement of comprehensive income
For the year ended 31 December 20X2 (function)

	20X2	**20X1**
	C	**C**
Revenue	X	X
Other income	X	X
Cost of sales	(X)	(X)
Distribution costs	(X)	(X)
Administration costs	(X)	(X)
Other costs	(X)	(X)
Finance costs	(X)	(X)
Profit (or loss) before tax	X	X
Taxation	(X)	(X)
Profit (or loss) for the year	X	X
Other comprehensive income	X	X
• Gain on available-for-sale financial assets	X	X
• Increase in revaluation surplus	X	X
Total comprehensive income	X	X
Profit for the year attributable to:	X	X
- owners of the parent	X	X
- minority interest	X	X
Total comprehensive income for the year attributable to:	X	X
- owners of the parent	X	X
- minority interest	X	X

7.5 The statement of changes in equity

7.5.1 Overview

A change in equity is simply the increase or decrease in the net assets of the entity (or referred to as a change in position). Such a change is represented by one or more of the following:
- transactions with owners; and
- total comprehensive income.

Components of equity include:
- each class of contributed equity (e.g. ordinary shares and preference shares);
- retained earnings;
- five possible classes of comprehensive income:
  - (1) revaluation surplus; (2) gains and losses on available-for-sale financial assets; (3) actuarial gains and losses on defined benefit plans; (4) gains and losses on effective cash flow hedges; and (5) gains and losses on translation of foreign operations.

7.5.2 Disclosure: in the statement of changes in equity (IAS 1.106-110)

The following must be disclosed in the statement of changes in equity:
- for each component of equity:
  - the effect of any change in accounting policy;
  - the effect of any correction of error; and
  - a detailed reconciliation between opening and closing balances for the period;
- total comprehensive income for the period;
- the transactions with owners in their capacity as owners, showing separately:
  - contributions by owners; and
  - distributions to owners.

If there has been a change in accounting policy or a correction of error, the effect of the adjustment or restatement on the balances must be disclosed:
- for each prior period; and
- the beginning of the current period.

If the financial statements are being prepared for a *group* of companies (as opposed to a single company), then disclosure must also include the allocation of total comprehensive income to:
- owners of the parent; and
- minority interests.

7.5.3 Disclosure: either in the statement of changes in equity or notes (IAS 1.107; 1.137)

Dividends recognised during the year need to be disclosed
- in total; and
- per share.

A dividend distribution normally follows the following life-cycle:
- proposal; then
- declaration; then
- payment

Dividends are first *proposed* in a meeting. If the proposal is accepted, the entity will *declare* the dividend. According to IAS 10 (paragraph 13), a declared dividend is a dividend that is appropriately authorised and no longer at the discretion of the entity. Declaring a dividend means publicly announcing that the dividend will be paid on a specific date in the future. It is only when the declaration is made, that the entity effectively creates an obligation to pay the dividend. It is therefore only on the date of declaration that a journal is passed to recognise the liability to pay dividends (no journal is processed when the dividend is proposed):

	Debit	**Credit**
Dividends declared (distribution of equity)	Xxx	
Dividends payable (liability)		Xxx
Dividend declared		

Remember that a dividend declared is not recognised as an *expense* but rather as a *distribution of equity* because it does not meet the definition of an expense (read this definition again).

Some dividends are *not recognised* as distributions to equity holders since there is no obligation to pay them at the end of the reporting period. These include dividends that are:
- proposed before or after the reporting date but are not yet declared or paid; and
- declared after reporting date but before the financial statements are authorised for issue.

The total of the above dividends that have *not* been recognised must be *disclosed* in the notes:
- in total; and
- per share.

The amount of any cumulative preference dividends that, for some reason, have not been recognised must also be disclosed in the notes.

7.5.4 A typical statement of changes in equity

7.5.4.1 Sample statement of changes in equity for a simplified, single entity

This example shows a statement of changes that might apply to a *single* entity. This statement of changes in equity has been further simplified to show a very basic spread of equity types (i.e. it does not have reserves other than retained earnings and has only one type of share capital: ordinary shares).

ABC Ltd
Statement of changes in equity
For the year ended 31 December 20X2

	Share capital C	**Share premium C**	**Retained earnings C**	**Total equity C**
Balance: 1 January 20X1 - restated	**X**	**X**	**X**	**X**
Balance: 1 January 20X1: as previously reported			**X**	
Change in accounting policy			**X**	
Correction of error			**X**	
Total comprehensive income			X	
Less dividends declared			(X)	
Add issue of shares	X	X		
Balance: 31 December 20X1 - restated	**X**	**X**	**X**	**X**
Balance: 31 December 20X2: as previously reported			**X**	
Change in accounting policy			**X**	
Correction of error			**X**	
Total comprehensive income			X	
Less dividends declared			(X)	
Add issue of shares	X	X		
Balance: 31 December 20X2	**X**	**X**	**X**	**X**

7.5.4.2 Sample statement of changes in equity for a group of entities

This example of a statement of changes in equity shows one for a *group* of entities. If the statement of comprehensive income shows a group of entities, there needs to be extra columns to show the allocation of total equity between the:
- owners of the parent; and
- minority interests.

This example also includes more columns that the first simplified example of a statement of comprehensive income: it now includes a translation reserve, available for sale reserve and a revaluation surplus.

The columns in the statement of changes in equity for your entity might be fewer or more than those shown in the examples. It depends on:
- what columns are relevant to the entity (e.g. if the entity does not have foreign operations, then a translation reserve would not be necessary); and
- the materiality of the reserves.

Some other equity accounts that you may find that would require separate columns include:
- capital accounts: stated capital and preference share capital;
- statutory reserve: capital redemption reserve fund;
- non-distributable reserve: revaluation reserve (surplus) or asset replacement reserve; and
- cash flow hedge reserves (of effective portion of gains and losses)
- general reserves.

ABC Ltd
Consolidated statement of changes in equity
For the year ended 31 December 20X2

	Attributable to owners of the parent						Minority interest	Total equity
	Share capital	Available for sale assets	Translation reserve	Revaluation surplus	Retained earnings	Total equity		
	C	C	C	C	C	C	C	C
Balance: 1 Jan 20X1 - restated	**X**	**X**	**X**	**(X)**	**X**	**X**	**X**	**X**
Balance: 1 Jan 20X1 - as previously reported						*X*		
Change in acc. policy						*(X)*		
Total comprehensive income		**X**	**X**	**X**	**X**	**X**	**X**	**X**
Less dividends					(X)	(X)	(X)	(X)
Add share issue	X	X				X		X
Balance: 31 Dec 20X1 - restated	**X**	**X**	**X**	**(X)**	**X**	**X**	**X**	**X**
Balance: 31 Dec 20X1 - as previously reported						*X*		
Change in accounting policy						*(X)*		
Total comprehensive income		**(X)**	**X**	**(X)**	**X**	**X**	**X**	**X**
Transfer to retained earnings				(X)	X			
Less dividends					(X)	(X)	(X)	(X)
Add share issue	X	X				X		X
Balance: 31 Dec 20X2	**X**	**X**	**X**	**(X)**	**X**	**X**	**X**	**X**

7.5.4.3 Exam technique

The total comprehensive income in the statement of comprehensive income is equal to the total comprehensive income shown on the face of the statement of changes in equity. If you are required to present both a statement of comprehensive income and a statement of changes in equity, then good exam technique would be to start with the statement of comprehensive income and then, when preparing your statement of changes in equity, put the total comprehensive income per your statement of comprehensive income into your statement of changes in equity.

7.6 The statement of cash flows (IAS 1.111)

7.6.1 Overview

The statement of cash flows gives information regarding the entity's cash flow broken down into the three main areas of activity, namely:

- operating activities;
- investing activities; and
- financing activities.

This statement is useful in assessing the ability of the entity to generate cash and cash equivalents and the company's related need for cash.

A separate standard (IAS 7) covers this component in detail and therefore the 'statement of cash flows' is covered in its very own chapter.

7.7 The notes to the financial statements (IAS 1.112-124)

7.7.1 Overview

Notes give additional information about:
- items that are included in the other four statements; and
- items that are not included in the other four statements yet which, for one reason or another, do require separate disclosure;
- whether the financial statements comply with all IFRSs;
- basis of preparation and the significant accounting policies;
- measurement bases;
- sources of estimation uncertainty;
- how the entity manages its capital (i.e. what are its objectives, policies and processes in this regard).

7.7.2 Structure of the notes (IAS 1.112-117 and IAS 1.122)

The notes must be presented in a systematic and logical manner. The other four statements making up the financial statements must be cross-referenced to the notes. Notes supporting items in the other four components should be listed in the same order that each line item and each financial statement is presented (on occasion, a note may refer to more than one line item, in which case one must simply try to be as systematic as possible).

The following order or structure is normally followed:
- statement of compliance with International Financial Reporting Standards;
- a summary of significant accounting policies used including:
  - a statement of the measurement basis (or bases) used in preparing the financial statements (e.g. historical cost, fair value etcetera); and
  - the accounting policies used that would help to understand the financial statements;
  - the judgements that management made in applying its accounting policies that had the most significant effect on amounts recognised in the financial statements;
  - this summary can be presented as a separate statement in the financial statements, with the result that there would be *six* statements making up the financial statements;
- supporting information for items included in the other four components that:
  - must be separately disclosed according to IFRS and/or the statutory requirements (e.g. the different classes of inventory making up the balance in the statement of financial position);
  - must be separately disclosed in order to improve understanding; and
- information regarding other items that are not included in the other four components that:
  - must be separately disclosed according to IFRS and/or the statutory requirements (e.g. contingent liabilities; commitments and details of events that happened after the reporting date but before the financial statements were authorised for issue);
  - non-financial disclosures (e.g. the entities objectives and policies regarding its financial risk management); and
  - judgements that management has made that have had the most significant effect on the amounts in the financial statements (these can be presented as part of the accounting policy note instead of as a separate note on significant judgements).

7.7.3 Disclosure of accounting policies (IAS 1.117 – 124 and 125)

7.7.3.1 Overview

The summary of significant accounting policies would include:
- The measurement basis or bases used in preparing the financial statements, for example:
  - Historical cost
  - Current cost
  - Net realisable value
  - Fair values
  - Recoverable amounts; and

- Other accounting polices that would help users understand the financial statements; and
- Judgements that management has had to make in applying accounting policies, example:
  - whether the entity's financial assets should be classified as available-for-sale or held-to maturity etc (each classification would be measured differently);
  - whether certain sales are actually disguised financing arrangements, which would then not result in revenue; and
- Judgements that management make regarding the future and estimation of amounts: source of estimation uncertainty.

7.7.3.2 Significant and relevant

Only the accounting policies that are *significant* to an entity need to be disclosed. Accounting policies may be considered *significant* even if the amounts related thereto are *immaterial*. When deciding whether or not to disclose an accounting policy, one should consider whether or not it would assist the user in understanding the performance and position of the entity.

Here are a few examples of accounting policies that may be relevant to an entity:
- whether property, plant and equipment is measured at fair value less subsequent depreciation or historical cost less depreciation and what rates of depreciation are used;
- the fact that deferred tax is recognised and measured using the comprehensive basis and whether deferred tax assets are recognised;
- when revenue is recognised and how it is measured; and
- any accounting policy devised by management in the absence of an IFRS requirement.

Whether an accounting policy is relevant to an entity depends largely on the nature of its operations. For example, if an entity is not taxed, then including accounting policies relating to tax and deferred tax would be a silly idea!

7.7.3.3 Judgements made by management

The standard refers to two types of judgements made by management:
- Judgements made by management in deciding which accounting policies to apply;
- Judgements made by management in making estimates: sources of estimation uncertainty.

Judgements made by management in the application of accounting policies (i.e. other than those involving actual estimations) that have had a significant effect on the amounts recognised in the financial statements should be disclosed. An example of such a judgement would be when management decides that one of the buildings owned is 'held for sale' (i.e. not 'held for use') with the result that *IAS 40: Investment property* is used to account for that building instead of *IAS 16: Property, plant and equipment*. These judgements may be disclosed either with the list of significant accounting policies or as a separate note.

Judgements made by management in making actual estimates are referred to as *sources of estimation uncertainty*. Making estimates requires a subjective assessment of many things, including the future – a difficult task indeed! For this reason, information about these judgements is typically included as a separate note (i.e. not in the summary of significant accounting policies). Sources of estimation uncertainty are discussed below in more depth.

7.7.4 Sources of estimation uncertainty (IAS 1.125 – 133)

Drawing up financial statements involves many estimates. These estimates involve professional judgements, from the decision regarding depreciation rates to the assessment of the entity to continue as a going concern. These estimates involve both an assessment of sources of uncertainty at reporting date and in the future. Where an assumption has been made regarding uncertainties (e.g. the life of an asset, future selling prices, future costs, future interest rates), that involve a high degree of subjective and complex 'guesswork', there is, of course, a *risk* of being 'wrong.'

Disclosure is required when this possibility of being wrong amounts to:

- a *significant* risk
- that a *material* adjustment to the carrying amount of an asset or liability
- may need to be made *within the next financial year*.

The disclosure would need to include:

- the nature and carrying amount of the assets and liabilities affected;
- nature of the assumption or estimation uncertainty;
- sensitivity of the carrying amounts to the methods, assumptions and estimates used in their calculation;
- reasons for the sensitivity;
- range of reasonably possible carrying amounts within the next financial year; and
- changes made (if any) to past assumptions if the uncertainty still exists.

If an asset or liability is measured at fair value based on market prices, and there is a significant risk of its carrying amount changing materially within the next year, no disclosure is required since the change in its carrying amount is caused by the market price changing and is not caused by incorrect assumptions made by management.

Example 17: sources of estimation uncertainty

Weezy Limited is a petrochemical company that has a bad reputation for environmental pollution. It has recently been presented with numerous legal claims from residents in the surrounding neighbourhood.

Required:
Explain the issues that Weezy Limited must consider when complying with IAS 1 requirement's regarding 'sources of estimation uncertainty'.

Solution to example 17: sources of estimation uncertainty

There are two areas of concern for Weezy Limited where assumptions made by management involve a high degree of risk that a material adjustment to an asset or liability may be required in the next year.
In this regard, management must decide:

- Recognition and measurement: whether it must make provisions for restoration of the environment due to the impact of pollution possibly caused by it. This will require assumptions regarding the amounts and timings of the likely cash flows.
- Disclosure: what to disclose regarding the likely outcome, amounts of damage probable and the timing of such payments pursuant to the recent legal claims received.

7.7.5 Capital management (IAS 1.134-135)

An entity must disclose its objectives, policies and processes for managing its capital. In so doing, the disclosure must include:

- qualitative information regarding the objectives, policies and processes for managing its capital, including at least the following information:
  - a description of what it considers to be capital;
  - the nature of any externally imposed capital requirements
  - how externally imposed capital requirements (if any) have been incorporated into the entity's management of capital
  - how it is meeting its objectives for managing capital;
- quantitative information regarding what it considers to be capital (since the term *capital* is not defined):
  - some entities *include* some financial liabilities when talking about their capital (e.g. the entity may manage its subordinated debt as part of its capital); while
  - some entities *exclude* certain equity accounts from their idea of capital (e.g. the entity may not consider its cash flow hedge reserves to be part of capital);
- changes to the information provided above from the prior year;

- whether it complied with the externally imposed capital requirements (if applicable) during the period; and
- the consequences of non-compliance with externally imposed capital requirements (if applicable).

7.7.6 Other disclosure required in the notes (IAS 1.137-138)

Other information requiring disclosure includes:
- the domicile and legal form of the entity;
- which country it was incorporated in;
- the address of its registered office or principal place of business;
- a description of the nature of the entity's operations and principal activities; and
- the name of the parent entity and the ultimate parent of the group (where applicable).

The notes must also include the following information relating to unrecognised dividends:
- the amount of any dividend proposed before the financial statements were authorised for issue and the dividend per share;
- the amount of any dividend declared before the financial statements were authorised for issue and the dividend per share; and
- the amount of any cumulative preferences dividends not recognised.

8. Summary

The Pillars

- **Framework**
  - Framework for the preparation and presentation of financial statements
    - objectives of financial statements
    - underlying assumptions
    - qualitative characteristics
    - the elements
    - recognition of the elements
    - measurement of the elements
- **IAS 1**
  - Presentation of financial statements
    - objective of IAS 1
    - objective of financial statements
    - the 5 statements in a set of fin. statements
    - the 8 general features
    - the structure & content of fin. statements

Objective of f/statements

- providing info about the: financial position, perform. & cash flows
- that is useful to a wide range of users in making eco. decisions; and
- showing the results of mgmt's stewardship of the resources entrusted to it.

Underlying assumptions

- accrual basis
- going concern

Qualitative characteristics

- understandability
- relevance
- reliability
- comparability.

Recognition & measurement

Recognition:
- meet definition
- meet recognition criteria

Measurement:
- historical cost
- current cost
- present values
- fair values
- liquidation values
- etc

General features

- fair presentation & compliance with IFRS;
- going concern;
- accrual basis;
- materiality and aggregation;
- offsetting;
- reporting frequency;
- comparative information;
- consistency.

The financial statements comprise:

Statement of financial position

Financial position: assets, liabilities and equity

Statement of changes in equity

Changes in financial position: movement in equity (issued capital and reserves)
Detail given for transactions with owners

Statement of comprehensive income

Financial performance: income and expenses

Statement of cash flows

Cash generating ability:
Cash movements analysed into:
- operating
- investing and
- financing activities

Notes to the fin. statements

Basis of preparation;
Accounting policies;
Information not disclosed in other statements that need to be disclosed

Elements in the financial statements

Assets

- Resource
- Controlled by the entity
- As a result of a past event
- From which future economic benefits are expected to flow to the entity

Liabilities

- Present obligation
- Of the entity
- As a result of a past event
- From which future economic benefits are expected to flow from the entity

Equity

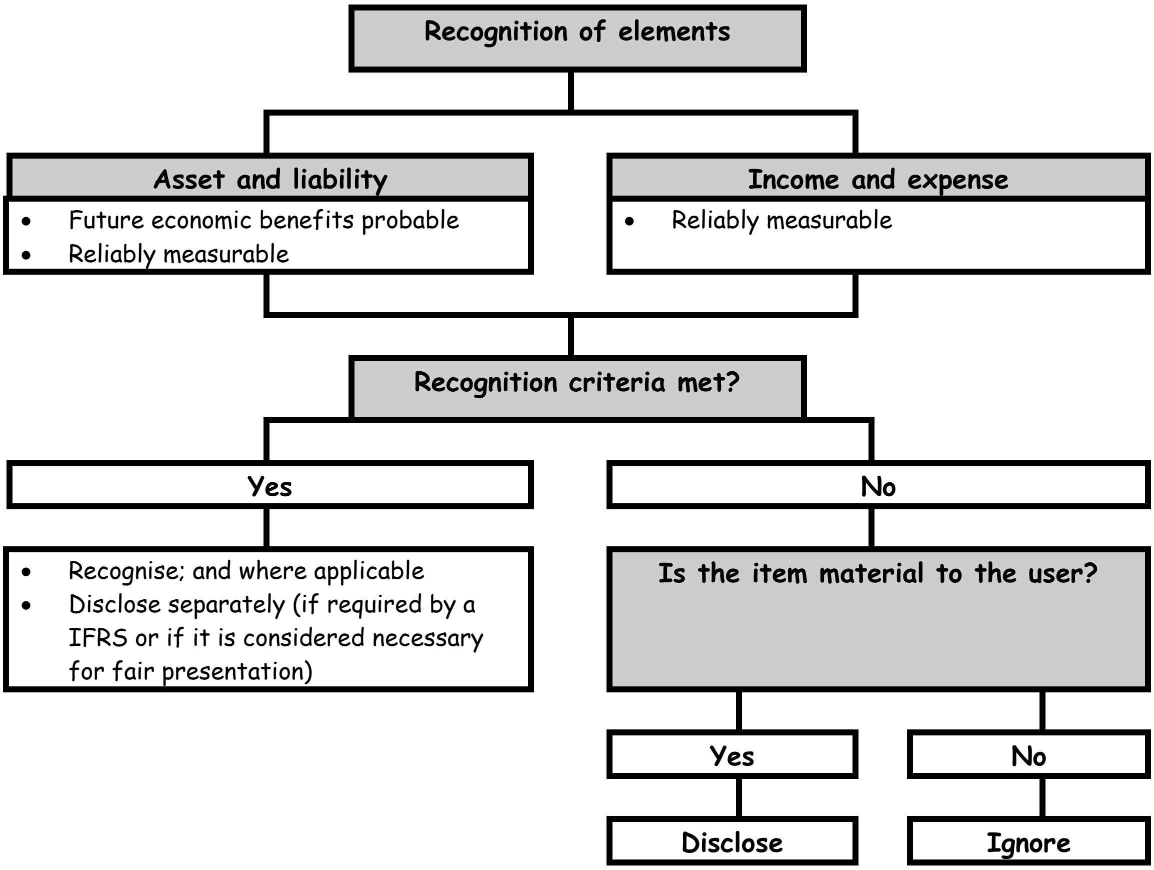
- Assets less
- Liabilities

Income

- An increase in economic benefits
- During the accounting period
- In the form of increases in assets or decreases in liabilities
- Resulting in increases in equity
- Other than contributions from equity participants

Expenses

- A decrease in economic benefits
- During the accounting period
- In the form of decreases in assets or increases in liabilities
- Resulting in decreases in equity
- Other than distributions to equity participants


Recognition of elements
Asset and liability
• Future economic benefits probable
• Reliably measurable
Income and expense
• Reliably measurable
Recognition criteria met?
Yes
No
• Recognise; and where applicable
• Disclose separately (if required by a IFRS or if it is considered necessary for fair presentation)
Is the item material to the user?
Yes
No
Disclose
Ignore