Education and Culture DG

Lifelong Learning Programme

LEONARDO DA VINCI
Transfer of Innovation

Leonardo da Vinci programme project

„Development and Approbation of Applied Courses Based on the Transfer of Teaching Innovations in Finance and Management for Further Education of Entrepreneurs and Specialists in Latvia, Lithuania and Bulgaria"

Applying International Financial Reporting Standards

Institute of Professional Financial Managers
London, UK

2010

Applying International Financial Reporting Standards

Contents

Course Introduction

The course "Applying International Financial Reporting Standards" has been prepared by adapting educational material developed by Institute of Professional Financial Managers published in Riga by Dr. Irina Kuzmina (Latvia) and Dr. Philip Dunn (United Kingdom)[1].

Motivation for Developing the Course

Research by the members of the project consortium Employers' Confederation of Latvia and Bulgarian Chamber of Commerce and Industry indicated the need for further education courses. International Financial Reporting Standards:

- reflect the needs of a business in modern market economy;
- have enjoyed wide international acceptance;
- are often easier to apply compared to known national standards;
- listed companies in the EU have to apply IFRS;

Thus, IFRS were identified as a priority area for improving knowledge among local finance and accounting professionals.

Innovative Content of the Course

The course is developed to include the following innovative content:

- the terms used in IFRS and their equivalents in national accounting standards;
- solving applied problems in financial reporting with a special emphasis on alternative ways of achieving reporting goals;
- the standards relating to transaction in shares and accounting for investments, which relatively few specialists are familiar with in Latvia;

Innovative Teaching Methods of the Course

The course is developed to utilise the following innovative teaching methods:

- Availability on the electronic platform with interactive learning and interactive evaluation methods;
- Active use of participant centered learning;
- Availability in modular form;
- Utilising two forms of learning - self-study and tutorial consultations;
- Availability in several languages simultaneously.

Target Audience for the Course

The target audience are: entrepreneurs, finance and management specialists from Latvia, Lithuania and Bulgaria, who wish to have practical skills in applying IFRS and, in the longer term, similar groups in any other European country.
The course assumes some prior experience in accounting, which is necessary to draw comparisons between IFRS and existing standards.
The course is intended for 64 academic contact hours or for self-study online and contains 140 pages of material.

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[1] И. Кузьмина, Ф. Данн Международные стандарты финансовой отчетности, Institute of Professional Financial Managers, Рига, ABC Balt, 2005

Course Objectives

After completing the course, the audience should be able to:
1. Understand the importance and meaning of regulation norms;
2. Understand the objectives of conceptual norms;
3. Determine the probable users of financial reports and understand their needs;
4. Prepare financial reports in accordance with the requirements of IFRS, in particular:;
4.1 Prepare cash flow report;
4.2 Prepare consolidated financial reports;
5. Interpret financial reports;

Course Structure

1. Introduction to IFRS;
2. Basic Principles of Financial Reporting Using IFRS;
3. Applying IFRS to Create Financial Reports;
4. Accounting for Long-Term Assets: Fixed Assets;
5. Accounting for Long-Term Assets: Leasing;
6. Accounting for Long-Term Assets: Intangible Assets;
7. Investments and Participation in Joint Ventures;
8. Accounting for Inventories;
9. Accounting for Financial Instruments;
10. Liabilities and Provisions;
11. Revenues;
12. Construction Contracts and Operating Segments;
13. Cash Flow Reports;
14. Consolidated Financial Statements and Accounting for Mergers.

1. Introduction to IFRS
This section covers the following topics:
- National Accounting and Reporting Systems and Factors Influencing Their Design.
- Differences in International Accounting Practices – introduces classification of national accounting systems.
- Regulation of Accounting. The Application and Role of IFRS - describes the rationale for creating IFRS and the relationship between this rationale and underlying principles of IFRS.

This and other sections include some short multiple choice questions, which are intended to aid self-study and revision.

2. Framework of Principles for the Preparation of Financial Statements According to IFRS
This section covers the following topics:
- Conceptual foundations of IFRS.
- Qualitative characteristics of financial reports.
- Elements of financial reports.
- Creating financial reports and their content.
- Basic principles of financial reporting and their application in IFRS.

In the more applied sections that follow, content is illustrated with examples - e.g. a firm's balance sheet is constructed step by step based on the description of accounting events in the reporting period.

3. Applying IFRS to Create Financial Reports

In this section the focus becomes increasingly more on application covering:

- Balance sheet - covering two possible formats of the balance sheet (based on net assets and equity, or assets, equity and liabilities).
- Profit / Loss account - again two possible formats are contrasted focusing either on the cost of goods sold (function of expenditure) or expenses (elements of expenditure).
- Statement of changes in equity.
- Operations in foreign currency and the influence of exchange rates.
- Remarks on financial reports - previewing content further along the course: policies for recognising revenue, accounting for inventories, taxation, etc.

4. Accounting for Long-Term Assets: Fixed Assets

This section covers:

- Relevant definitions - e.g. depreciation, residual value, fair value, etc.;
- Criteria for recognising long-term assets;
- Depreciation, loss of value of assets, specifying information in reports and other topics;
- This section also includes 5 applied problems, e.g:
  In 20X9, company N has sold a car, which was acquired three years earlier for Ls 4,000. Initial value of the car was Ls 9,600 and the amount of accumulated depreciation at the moment of writing off the asset was Ls 5,760. *Required*: 1) Make the necessary accounting records; 2) Determine financial result "Excluding Transport Vehicles" and determine financial result of this transaction.

5. Accounting for Long-Term Assets: Leasing

This section covers relevant definitions and classification of leasing transactions.
Focusing on financial leasing, accounting procedures both for lessor and lessee are discussed.
There are several examples and two applied problems in this section, which require the audience to compute the graphic of leasing payments given the value of assets, interest rates, residual value, or to compute the implied interest rate in leasing transaction given other relevant information.

6. Accounting for Long-Term Assets: Intangible Assets

This section covers the following topics:

- Recognising intangible assets and appropriate definitions.
- Valuing and depreciating intangible assets.
- Valuing and depreciating goodwill.

Intangible assets are relatively new area for accountants in Latvia, thus detailed discussions are provided on how to deal with assets such as software licenses, copyright on product samples, trademarks, media content, etc.

7. Investments and Participation in Joint Ventures

This section covers the following topics:

- General approach to accounting for investments; Classification of investments.
- Investments in subsidiaries and associated companies.
- Investments in property.
- Investments in joint ventures.
- Shares and participation in equity.

8. Accounting for Inventories

This section covers the following topics:

- Types of inventories;

- Methods of accounting for inventories;
- Inventory valuation methods with detailed flowcharts illustrating the application of the method;
- The influence of inventory valuation methods on financial reporting indicators;
- Mistakes in inventory valuation;

This section also includes several applied problems and examples.

9. Accounting for Financial Instruments

This section covers the following topics:

- Financial instruments;
- Financial assets and financial liabilities;
- Recognizing financial assets and financial liabilities.
- Valuation of financial instruments;

This section also includes applied problems.

10. Liabilities and Provisions

This section covers the following topics:

- The notion of liabilities and provisions;
- Contingent assets and contingent liabilities;
- Deferred taxes.

11. Revenues

This section consists of the following topics:

- Accounting based on the accruals method;
- The concept of revenue and their valuation. Methods of recognising revenues;
- Trading discounts;
- Dubious and bad debts;
- Selling merchandise on the basis of consignment;
- Accounting for government subsidies;

There are more than 25 applied examples and questions in this section.

12. Construction Contracts and Operating Segments

This section covers the following:

- Description of construction contracts;
- Financial result of construction contracts;
- Disclosure of information about construction contracts;
- Reporting on operating segments.

13. Cash Flow Reports

This section covers the following:

- The function of cash flow report;
- The principles of preparing cash flow report;
- The methods of preparing cash flow report;
- This section also contains a test with more than 25 questions and applied problems.

14. Consolidated Financial Statements and Accounting for Mergers

This section covers the following:

- Company group reports - draws distinction between purchases, mergers and consolidation;
- Accounting for company acquisition - considers two different methods with examples;
- Principles of consolidation - focuses on treatment of dividends, minority share, etc.

Summary of the Course

The course provides the target audience with a broad knowledge about International Financial Reporting Standards and their application.
The focus is on practical application of knowledge – entrepreneurs and finance specialists using the course and questions of the course to solve accounting problems in their own company.
The course can be combined with other further professional education courses developed within the project.

1. Introduction to IFRS[2]- International Financial Reporting Standards

1.3. Factors affecting the national accounting and reporting system and their functioning

In the 19th century, as the stock companies became more popular, shareholders-owners emerged without sufficient knowledge of enterprise operations along with employed administration staff periodically in need of reporting to the owners. The necessity arose for reporting of such information that would be understandable to the shareholders and comparable to the reporting data of other enterprises.

Any national accounting system in the world is independent and is protecting the national interests of the country.

The factors defining the peculiarities of national accounting systems are as follows:

- influence of the leading theory writers and professional accountancy bodies;
- economic consequences arising from adopted systems;
- general economic situation in the country;
- tax policy;
- national peculiarities;
- users of financial data and their goals;
- legal environment;
- sources of financing;
- language;
- the general dominating atmosphere in the country.

Factors materially affecting the contents of national accounting and reporting standards:

- type of accounting information users (these can be both physical entity and either a bank or governmental bodies);
- copyright to the standards;
- amount of physical and legal entities forming the source of business capital;
- degree of involvement of investors in the management of this area of business;
- level of security market development.

1.2. Differences in the international accounting practice

In the current stage of social development all countries can be divided into the two following groups:

- countries with a well-structured legislative framework;
- Countries with legislation of general judicial development.

[2] IFRS – International Financial Reporting Standards

In the first group of countries laws are a set of merciless rules designed according to the principle ***'You are obliged to…!'***, i.e., allowed only if expressly permitted in the law.

The responsibility of both physical and legal entities is to literally obey the rules laid down in the legislation which are provided for each even the smallest of the cases.

Accounting standards which are approved at the government level are introduced by the force of law. Any accounting procedures are laid down in a detail, and the tax accounts and the possibility to control their full and due payment to the budget becomes the main accounting objective.

The second group of countries develop their laws in the form of series of restrictions following the principle ***'You shall not be allowed to…!'***, i.e., anything that is not forbidden is allowed.

Legislation establishes a framework within which both physical and legal entities may act freely. In this case the state does not regulate the accountancy laws, being designed by multiple non-government organisations bringing together professional accountants.

Accounting becomes turns into a creative process; it includes designing of systems, preparation of estimates, cost analysis, audit inspections, profit and tax planning. This difference in the approaches for designing the accounting systems can be explained due to the fact that in the majority of countries with strict legal regulation the financial needs of companies are fulfilled on the account of governments and banks. Business in countries with orientation on the general judicial legislation uses the share capital and securities markets.

The country models can be in more detail subdivided as follows:

- **The British – American – Dutch Model:**

- highly-developed securities market;
- many multinational corporation (MNC) centres established;
- accounting is focussed on the information requirements of investors and creditors.

- **The Continental Model** (Japan and the European countries – France, Germany, Switzerland, Austria, Belgium, Denmark etc.):
  - businesses are closely connected to the banks;
  - statutory publication of annual reports;
  - prudent accountancy procedures, which are strictly regulated pursuant to the law;
  - priority issue – taxation.

- **The South American Model**
  - oriented to the needs of the government;
  - designing of special accounting techniques in consideration of the instability of the currency units, issues with the opening value estimation for fixed assets.

- **The Islamic Model**
  - usury forbidden;
  - company assets and debts are reported at market prices.

- **The International Model (IFRS used)**

The International Accounting Standards Committee was formed in 1973 through an agreement between the professional accounting bodies from Australia, Canada, Germany, Japan, Mexico, Indonesia, Ireland, Great Britain and the USA. Presently this organisation includes 14 professional accountancy body members in 105 countries.

Objectives of the IASC:

- to formulate and publish accounting standards;

- to introduce the accounting standards world wide;
- to assist countries in developing their own standards;
- to assist in application of IFRS and to find solutions for their application;
- to assist auditors in preparing their opinions in conformity with IFRS;
- to assist users of financial statements to interpret the information.

International financial reporting standards were developed due to the economic and national differences in various countries after long and multiple alignment processes.

They are advisory by nature in respect of the national accounting models and their goal is to achieve the comparability of these systems.

1.3. Accounting regulation, the meaning of IFRS, their application and role

All of the currently adopted accounting standards can be conditionally grouped in the following categories pursuant to the degree of standardisation of accounting:

- national standards, the application of which is statutory in a specific country;
- national standards, the application of which is statutory in countries of specific regions;
- international financial reporting standards which are developed for application in countries world wide.

In parallel to the process of accounting standardisation at the regional level, the common international accounting system is also developed.

The generally accepted accounting principles form the basis of the international accounting system, and there are common financial accounting and reporting standards established to enable the comparability of enterprise operations world wide.

The purpose of establishing the international financial reporting standards is the harmonisation of national accounting and reporting systems in order to improve the quality of use of the company financing, and particularly of the trans-national companies.

IFRS are created at the international level and they are drafted by the International Accounting Standards Board.

At present these international standards are named ‘International Financial Reporting Standards’.

The international standards (IFRS):

- reflect the peculiarities of the market economy;
- have acquired wide international recognition;
- are relatively simple compared to known national standards;
- require less cost for the development and enforcement of own (national) standards;
- open for amendments - there is a possibility to influence their development by participating in the working process of professional organisations.

According to substance IFRS:

- comprise accounting and presentation of reports for tangible and intangible assets, financial instruments, liabilities, reserves, issued capital, revenues and expenses;
- regulate the preparation of reports in circumstances of hyperinflation;
- provide with the methods for preparation of consolidated financial statements in accordance with the different enterprise merger techniques;
- offer accounting for impairment of asset value;
- reflect accounting for contingencies;
- provide for winding-up of enterprise operations;
- provide solutions for several other reporting issues.

Unification of accounting means the elimination of differences between the methods of accounting for business transactions, events and conditions.

Along with the unification of accounting methods the necessity for defining the terminology of objects of accounting in an accurate way occurs.

The process of unification[3] usually is understood either as ***harmonisation***, or as ***standardisation***. Most recently the trend for harmonisation, alignment of the national accounting systems is expressly felt across the world. This trend reflects the internationalisation of economics, and first of all in the area of business.

The following reasons are pointed out as the main pretext for harmonisation of the national accounting systems:

- the world is becoming economically more closely connected;
- financial markets acquire global scale;
- the trans-national corporations are extending their area of activity.

The concept of harmonisation of different accounting systems is implemented inside the European Union: each country may have its own model of structuring accounts and system of standards governing it. The principal requirement is that these standards are not contradictory to other similar standards in member countries within the association.

The concept of standardisation of accounting procedures is realised within the framework of accounting unification and is performed by the International Accounting Standards Board: a unified set of standards should exist that can be applied to any situation and in each of the countries.

The International Accounting Standards Board ***does not attempt to enforce absolutely identical principles of accounting***. This can be explained by the following reasons:

- comprehensive unification of accounting procedures interferes with the freedom of enterprise management;
- financial statements become comparable by form only and not in substance;
- as new objects of accounting appear, the progress and development of practical accounting is slowed down.

On the practical side the accounting principles are unified for the following purposes:

1. The work is made more easy for the trans-national corporations due to the fact that:
    - the costs incurred in preparation of accounts for each individual company are reduced;
    - the company expenses are reduced as the amount of accounting adjustment documents required for the summary, i.e., consolidation decreases;
    - it is easier for companies to consolidate the internal and the external reporting documents and to arrive at single operating figures.

2. The possibilities of using the services offered by professional accountants from different countries in the national markets.

3. It is ensured that the financial statements of companies based in different countries are acceptable to international and governmental bodies, including the handling of anti-dumping cases.

The most wide-spread accounting systems world wide - GAAP, EU directives and IFRS refer to various standardisation levels:

[3] Measures undertaken to minimise the methodological differences in applicable accounting systems.

- GAAP are national standards used in the USA;
- EU directives are regional standards with the objective of harmonising the national accounting systems of the EU member states;
- IFRS are provided for the purpose of harmonising the accounting systems in societies world wide.

2. Framework of Principles for the Preparation of Financial Statements According to IFRS[4]

2.1. Underlying concepts of IFRS

The accounting concepts as the basis of accounting rather form the overall accounting culture of accounting instead of providing exact instructions for work. The concept of financial accounting comprises the main theoretical principles for preparation of accounts and financial reporting. The concepts underlying the International Financial Reporting Standards (IFRS) are formulated in a separate document which states the basic principles for IFRS – 'The Framework for the Preparation and Presentation of Financial Statements'. This document specifically defines the objectives of the financial statements and the elements of financial statements appropriate for achieving of those objectives as well as the qualitative characteristics of the information required (Figure 1.1).

The above mentioned conceptual elements are in fact the principles underlying the accounting standards and providing guidance as to what the standards should look like and what criteria should be applied in the development of such standards.

2.2. Purpose and contents of Framework

Purpose and status:

- serve as the basis for review of the existing standards and development of new ones;
- serve as the basis for developing national standards;
- serve as the basis in formation of auditor's opinion as to whether financial statements conform or do not conform with international accounting standards.

Note: The above mentioned principles do not constitute the standards for either measuring or disclosing of information.

The scope of Framework includes the following:

- the objectives of financial statements;

[4] IFRS – International Financial Reporting Standards

- the qualitative characteristics that determine the usefulness of information in financial statements;
- the definition, recognition and measurement of the elements from which financial statements are constructed; and
- concepts of capital and capital maintenance.

The concept of financial accounting is based on an inner logic arising from the interests of financial information users. According to IFRS users of financial information include investors, employees, lenders, suppliers and other trade creditors, customers, government and their agencies as well as the public. Financial statements contain information on the following:

- the financial position of a company;
- the financial performance of a company;
- any changes in the financial position of a company.

2.3. Qualitative characteristics of financial statements

The qualitative characteristics of financial statements constitute the conceptual basis for the accounting system, comprising the following:

- the basics of accounting;
- the underlying assumptions for accounting;
- the set of accounting methods used in enterprises (enterprise accounting policies).

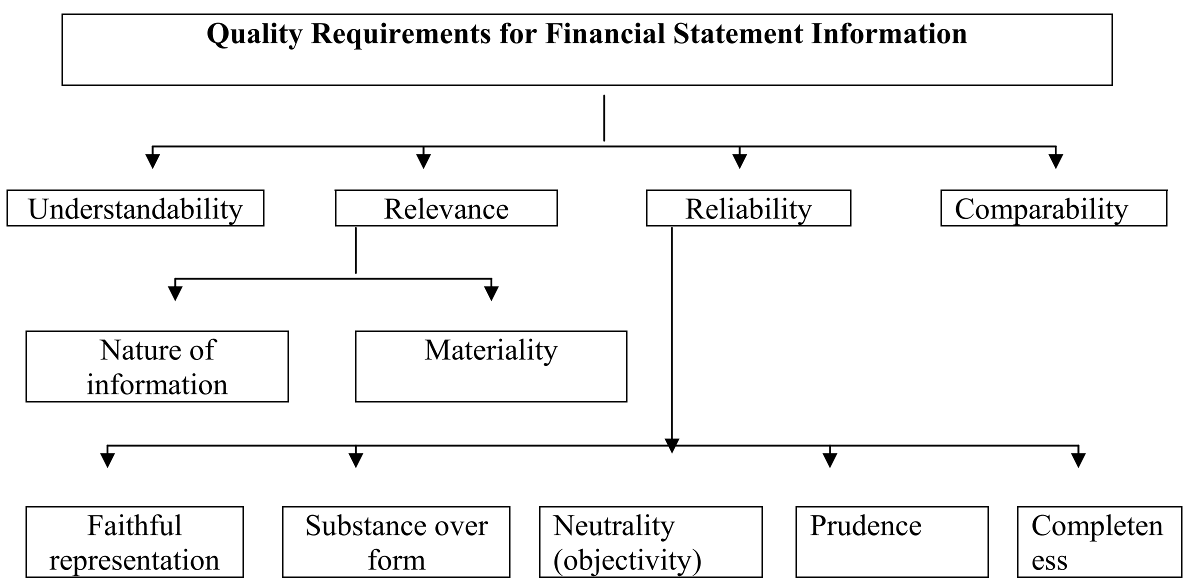


Figure 2.1 Qualitative characteristics of financial statements

- **Understandability**

Understandability or ‘transparency’ is the main quality of information. This requirement determines the form and the substance of reported information.

- **Relevance**

Information is relevant when it increases the level of certainty of an estimate or confirms previous evaluations. Relevance of information is affected by its nature and materiality.

- **Reliability**

  Information is reliable if it is free from material error and it is objective. Reliability is a complex concept described by five qualitative characteristics (Figure 1.1).

- **Comparability** – through time as well as with other enterprises' statements.

Business facts and business transactions are the objects of accounting. There are THREE issues that an accountant needs to resolve in practice:

1) **When** the business transaction took place (the issue of **recognition** in accounting);
2) What is the business transaction in terms of **value** (the issue of **evaluation**);
3) How should a business transaction be **qualified** (the issue of **qualification**).

While resolving those issues an accountant must follow the accounting standards and use the underlying assumptions based on which the accounting system is constructed.

2.4. Elements of financial statements

- Assets
- Liabilities
- Capital
- Income
- Expenses

Table 2.1. Elements of financial statements

Economic characteristics	**Element**	**Included in statements**
Directly related to changes in financial position	Assets Liabilities Capital	Balance Sheet
Directly related to changes in performance	Income Expenses	Income Statement

Definitions of the elements of financial statements only provide with general characteristics but do not give the criteria to which they should conform prior to recognition in the balance sheet.

Terms of recognition

In order to recognise an element in the statement it should conform to the following conditions:

1. The condition required for inclusion in the statement is the conformity to the definition of financial statements;
2. An insufficient condition for inclusion in the statement is the conformity to the criteria for recognition of the elements of financial statements consisting of the following two requirements:
   - there is a probability that an enterprise will acquire or lose future economic benefits that are associated with the object;
   - the object has a value that is measurable.

Measurement of the element of financial statements

Measurement is a process which helps to define amounts in terms of money in which the element of financial statements should be recognised in the balance sheet and the income statement. This requires the choice of specific measurement principles.

- ***Historical cost*** Assets are recorded at the amount of cash or cash equivalents paid at acquisition or the fair value of the other consideration given to acquire an asset. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances, at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

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

- ***Realisable value*** Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities if the normal course of business is maintained.

- ***Present value*** Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate if the normal course of business is maintained. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities if the normal course of business is maintained.

ASSETS

Assets – resources controlled by the enterprise as a result of past events, and from which future economic benefits are expected to flow to the enterprise. The following is directly attributable to the definition of assets.

The future economic benefit tied in the asset is the potential that may either directly or indirectly flow into the company cash assets or cash asset equivalents. An asset may be an item that can be:

- used in the production of goods and services sold by the company;
- exchanged for other assets;
- used for redemption of liabilities;
- distributed among the company owners.

Resources, **which are not capable of providing a certain future economic benefit**, are either a potential loss or current operating expenses and may not be classified as assets.

The physical form is not required for the existence of an asset (assets, for example, include patents and copyright (assets, for example, include patents and copyright, if a company acquires them for cash and expects an inflow of future economic benefits from their use).

Property rights are not a requirement for recognition of the existence of an asset (rented property is considered to be an asset as long as a company controls the profit which is expected from that property).

Resources acquired without any consideration from which a company expects the inflow of future benefits are also included in assets. The lack of expenses does not therefore exclude the possibility of asset creation in some circumstances.

Company expenses, on their turn, do not presuppose yet the acquisition of an asset. There should be **justifiable assurance for gaining of future economic benefits**, otherwise such expenditure should be attributed to current period expenses.

When **identifying** the assets in accounts it is necessary to take into account the legislation of the country of operation of the company.

Assets are recorded only after **past** transactions; the intention to purchase some assets may not be considered as a sufficient basis for recording of assets.

In order for an asset to be represented in the balance sheet it should have a cost or its value should be **reliable**.

EXPENSES

Expenses: decreases in economic benefits during an accounting period in the form of outflows, or depletions of assets or incurrences of liabilities that result in decreases in equity. Expenses may also arise due to incurrences of liabilities that result in decreases in equity (without the obligation of distribution of those liabilities among shareholders). The statements given below have a direct connection to the term 'expenses'.

Expenses are usually incurred in the result of business operations. These expenses make up the prime cost of goods sold and services provided and in financial statements are compared to income gained from their realisation (sales).

Unrealised income in a reporting period allows attribute expenses made purposefully in the interests of the respective items of income as assets as prepaid expenses, expenses to finance work in progress or stock of goods.

Losses from which no future benefits are expected are attributed to expenses.

Losses – reduction in capital arising from extraordinary transactions (natural disasters, sale of fixed assets, currency differences etc.) as well as in the result of ordinary transactions because the expenses incurred by them are not fully covered by income in the respective reporting period.

Expenses for ordinary transactions are recognised in the income statement in the same reporting period when incurred either in the form of asset decrease or liability increase in a close connection with the income generated by these transactions.

If the occurrence of economic benefits is expected over several accounting periods and if it is possible to track their relation to the income only generally or indirectly, the expenses are recognised in the income statement on the basis of the rational expense allocation method. This is necessary when recognising items of expense associated with the use of such assets as fixed assets, business image, for example. This method of allocation is provided for recognition of expenses in those reporting periods, during which the economic benefit associated with those items is consumed or lost.

Expenses are recognised in the income statement immediately if the costs do not generate any future benefits or if the expected economic benefits do not satisfy or no more satisfy the requirements for their recognition as a balance sheet item.

Expenses are recognised in the income statement also in those cases when liabilities have been incurred without recognising the asset, for example, the obligations under goods warranty.

Expenses incurred due to unusual or extraordinary events and transactions are reflected in the income statement as a loss for the reporting period when it has been made clear that they cannot serve as a source for gaining any future benefits.

Inclusion (recognition) of expenses in financial statements is in no way related to regulations of taxation. By estimating the financial results for a reporting period full expenses complying with the criteria of recognition must be considered regardless of whether they are included in the calculation of taxable profit or not.

LIABILITIES

Liabilities: present obligations of a company arising from the past events, the settlement of which is expected to result in an outflow of the company resources embodying economic benefits. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement.

The findings below will help to better understand the nature of liabilities.

Liabilities may include a certain obligation to repay a debt or the obligation act in an equitable manner (for example, to rectify faults of any goods sold, etc.).

Liabilities may be legally binding (as a consequence arising from contracts or statutory requirements) or they may arise from present transactions.

Sometimes liabilities can be established only with a certain degree of estimation. Provisions are established for such kind of liabilities. The Framework permits to consider only such provisions as liabilities the amount of which cannot be accurately established, or if the author of the statements cannot establish with a sufficient degree of reliability that the liability will be incurred in the future.

A distinction needs to be drawn between a present obligation and a future commitment. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset.

The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in several ways, for example, by:

- payment of cash;
- transfer of other assets;
- provision of services;
- replacement of that obligation with another obligation;
- conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

Obligations under contracts that are equally proportionally unperformed

(for example, liabilities for goods ordered, but not yet received) are not recognised as liabilities in the financial statements.

INCOME

Income: increases in economic benefit during an accounting period in the form of inflows or enhancements of assets, or decrease of liabilities that result in increases in equity, which, however, does not apply to the contributions made by the equity participants.

Two types of income are considered: income gained from sales (revenues) and other revenues (gains). The first type of income arises in the course of the ordinary current transactions (sale of goods and provision of services, interest received, dividends, rent etc.). The other type of income represents irregular, extraordinary income (disposal of fixed assets and slow-moving goods, currency differences, income from penalties etc.).

Only those items may be recognised as revenues that can be measured reliably and have a sufficient degree of certainty.

Income is recorded and included in the financial statements at the moment, when the claims for performance of the transaction are satisfied, and the majority of the property rights associated with the transaction is transferred to the buyer. Recognition of income occurs simultaneously with the recognition of increases in the assets or decreases in liabilities.

CAPITAL

Capital: residual assets of the enterprise after deducting all the liabilities.
Capital is the value of assets that will not be disposed of as a cover for the enterprise liabilities. The amount of capital depends on the basis of measurement of assets and liabilities and as a rule differs from the total value of shares of the enterprise as a going concern or the fair value of assets.

Capital (C) pursuant to the standards is defined as the difference between the assets (A) and liabilities (L) of an entity:

$C = A - L$

This definition arises from the following balance sheet equation:

$A = C + L$

According to the standards the total of capital and liabilities is not an independent category. This is why the standards do not reflect on the concept of 'Capital + Liabilities'.

The term 'Capital' includes the following:

- funds paid in by the shareholders (par value of shares and estimated profit or loss as a result of emission);
- retained and accumulated earnings;
- reserves made from accumulated earnings;
- reserves created as a result of adjustments and providing support for the capital (in connection with the asset revaluation or any amounts of grants, or assets acquired without a consideration).

When discovering the economic character of capital, two concepts are established in the standards – the financial and the physical concept of capital.

A close connection is established between the concept of capital and the concept of profit or the so called capital maintenance concept providing benchmarks for measuring the profit.

Under the **financial concept of capital** it reflects the amount of money invested in the entity and considered to be synonymous to capital.

Under the **physical concept of capital** it means the productive capacity of the entity based on, for example, units of output per day.

The entity may select the appropriate concept of capital based on the needs of the users of its financial reports.

Therefore, the financial concept of capital should be adopted if the users of financial reports are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital, while if the main concern of the users is with the operating capability - the physical concept of capital should be used.

These concepts give rise to:

- **Financial capital maintenance** – profit is earned only if the financial amount of the net assets at the end of the period exceeds the financial amount of net assets at the beginning of the period after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power. In the latter case only such a share of increase in the value of assets can be considered as an increase in profit which is higher than the overall increase in the price levels in the reporting period. Nominal asset value increase matching the increase in the overall price level is included in the capital inflation increase provision. The majority of entities adopted the financial concept of capital for their financial statements.

- **Physical capital maintenance** – profit is earned only if the physical productive capacity of the entity at the end of the period exceeds that at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

2. 5. Preparation of the form and substance of statements

Preparation of the forms and presentation of financial statements is established by IFRS 1 'Presentation of Financial Statements' according to which **a full set of financial statements shall include**:

- *Balance Sheet*
  The balance sheet (balance sheet statement) is a summary of the financial balances of an entity and their sources as offered in the British, Continental and American balance sheet layouts at the choice of the entity.

- *Income Statement or Profit and Loss Account*
  Income statement is a summary of all revenues and expenses by areas of activity – operating, other, extraordinary or discontinued, and is prepared in one of the two alternative layouts: expense format (by types of expenses) or the functional format (by expense items) – at the choice of the entity.

- *Statement of Changes in Equity*
  This statement is a summary of changes in the equity of an enterprise. The types of preparation of this report depend on the legal status of the enterprise.

- *Cash Flow Statement*
  This statement is prepared by using either the direct or the indirect method, on a cash basis, by grouping the items by the types of activity – operating, investing and financing activities. Enterprises specify the meanings of the types of activity in the contents of the cash flow statement items.

- *Accounting Policies and Explanatory Notes*

Identification of Financial Statements

Financial statements must be clearly identified and segregated from other information which is published within the same document.

Each component of the financial statements must be clearly identified. Besides, the information listed below must be visibly displayed and has to be repeated, if necessary, in order to properly understand the information provided.

- the enterprise title and other requisite details;
- whether the financial statements comprise a separate enterprise or a concern of enterprises;
- the balance sheet date, the period covered by the financial statements;
- currency used in the statements;
- the degree of accuracy of the figures disclosed in the financial statements.

Financial statements must be presented at least once a year. In exceptional cases when the balance sheet date is changed and when the financial statements are presented for a period above or less than one year, the enterprise apart from giving the period information must explain the following:

- reason for use of a period which is not equal to one year;

- the fact that the comparable amounts of the income statement, statement of changes in equity, the cash flow statement and the respective notes cannot be compared in fact.

Balance Sheet

The enterprise must establish whether it should present current and non-current assets and current and non-current liabilities as a separate classification in the main part of the balance sheet.
If the enterprise chooses not to provide such classification, both assets and liabilities must be presented in the order of their degree of liquidity.
Irrespective of the method of presentation adopted and used, each item of assets and liabilities including concurrently the amounts that the enterprise expects to recover and the amounts which it expects to settle both within and after a period of 12 months from the balance sheet date, the enterprise must explain the amount that it intends to recover or settle later than 12 months after the balance sheet date.

Current assets
An asset item must be classified as a current asset item, if:
- it is intended or held for re-sale or own consumption within the normal business cycle of an enterprise;
- it is held mainly for trading purposes or with the intention of turning them into cash shortly within 12 months after the balance sheet date;
- it is cash or cash equivalents without limitations as to their use.

All other assets must be classified as **non-current assets**.
Current liabilities
Liabilities should be classified as current liabilities if:
- they must be paid within the normal business cycle of the enterprise;
- the date of their settlement is due within 12 months after the balance sheet date.

Current liabilities can be grouped in the same way as current assets.
The enterprise must continue to classify its long-term liabilities together with the interest as non-current even if their settlement period falls within a 12 month period after the balance sheet date if:
- the initial term of these liabilities exceeded a period of 12 months;
- the enterprise intends to re-finance this obligation in accordance with long-term conditions;
- this intention is confirmed by an agreement to re-finance or alter the payment schedule and this agreement has been entered into before the permission is given to publish the financial reports.

Notes to the balance sheet must disclose the amount of all liability items excluded from current liabilities along with the information that prescribes such disclosure.

Information to be provided in the main section of the balance sheet
The basic section of the balance sheet must at least include line items in which the following amounts are presented:
- property, plant and equipment;
- intangible assets;
- financial assets;
- investments accounted for in accordance with the equity method;
- inventories;
- trade and other accounts receivable;

- cash and cash equivalents;
- trade and other accounts payable;
- taxation payable and receivable;
- accrued charges;
- non-current liabilities together with interest;
- minority interest;
- issued capital and reserves.

Additional line items, headings and sub-totals must be disclosed in the main section of the balance sheet if so required by the standards or if such disclosure is necessary to give a true and fair view of the financial position of the enterprise.
Separate disclosure of sub-items is decided first of all by evaluating the following:

- the nature of assets, their degree of liquidity or materiality;
- the function they perform in the enterprise;
- any amounts of liabilities, their nature and terms.

A more detailed breakdown of the line items should be given on the face of the enterprise balance sheet or under the notes section in such a way that best corresponds best to the enterprise activities. If necessary, each item should be further detailed by its nature, and the amounts payable or receivable from the mother companies, other related and associated enterprises of the same concern and other related parties must be disclosed separately.
The following information must be disclosed either in the main section or under the notes section:

1. For each class of share capital:
   - number or amount of shares authorised;
   - number of shares issued and fully paid for; number of shares issued and outstanding (not fully paid for);
   - par (nominal) value of shares or the fact that the shares do not carry a par value;
   - movement in share capital accounts during the period with reconciliation at the beginning and end of period;
   - rights, preferences and restrictions of each class of shares, also with respect to the distribution of dividends and to the repayment of capital;
   - shares owned by the enterprise itself or related and associated enterprises of the concern;
   - shares reserved for future issue under options and sales contracts, including the terms and amounts.
2. Description of the nature and purpose of each type of reserves included in equity.
3. Amount of dividends the discharge of which is proposed or announced after the balance sheet date, however, before the permission is given for publishing the financial reports.
4. The total amount of all cumulative dividends on preference shares not yet recognised.

Enterprises without the share capital, for example, partnerships, must disclose any information similar to the above required information showing the equity interest movement for the period and the rights, preferences and restrictions pertaining to each share of equity interest.

Income statement

Information to be provided on the face of the income statement
The main section of the income statement must at least include line items in which the following amounts are presented:

1. Sales revenue
2. Operating profit/(loss)
3. Financial expenses

4. The share of profit or loss of related enterprises and joint ventures accounted for according to the equity method
5. Taxation expenses
6. Profit or loss from ordinary activities
7. Extraordinary items
8. Minority interest
9. Net profit or loss for the period

Additional line items, headings and sub-totals must be disclosed in the main section of the income statement if so required by the standards or if such disclosure is necessary to give a true and fair view of the financial position of the enterprise.
Expense analysis by type of cost items or by functions they perform in the enterprise must be provided both on the face and in the notes section of the income statement.
Expense items must be classified into more detail in order to disclose the diversity of the component parts of business performance; they may vary according to the degree of stability, the potential of gains or losses and predictability.

Statement of Changes in Capital
As a separate component part of the financial statements the enterprise must present a statement showing:
- Net profit or loss for the period;
- Each item of revenues and costs, gains and losses that are required to be recognised directly in the equity and the total amount of these items;
- The cumulative effect of accounting policy changes and corrections of fundamental errors in accordance with the benchmark treatment.

Besides, the enterprise must disclose the following in the same statement or under the notes:
- Equity transactions with the owners and distribution of benefits to owners;
- The period opening balance of accumulated profit or loss account and as of the balance sheet date, and their movement during the period;
- Total amount for each class of equity, share premium and reserve class with reconciliation with the period opening and closing amounts by disclosing each movement item separately.

Notes to the Financial Statements
Under notes to the Financial Statements the following information should be disclosed:
- information about the basic concepts for preparing the financial statements and the specific accounting policies chosen and applied in regard to significant transactions and events;
- any information that is required by the standards and has not been disclosed anywhere else in the financial statements;
- additional information, which is not disclosed in the main section of the financial statements, but is required for presentation of fair and true information.

The notes must be presented in a systematic manner. Every item included in the main body of the balance sheet, the income statement or the cash flow statement must be disclosed with a reference to all related information included in the notes.
The notes are laid out in the following order:
- reference on consistency with the standards;
- listing of the principles of estimation and accounting policies applied;
- detailed information about the items;
- other disclosures.

2. 6. Underlying principles and policies for financial reporting according to IFRS

2.6.1. Four fundamental assumptions

Prudence - caution (conservative estimation).

If there is a choice given between two or more assessments of a business activity one should keep to the assessment providing with the lowest profit and/or the lowest net value. Being conservative essentially means that accountants should take into consideration the lowest of the possible asset and revenue amounts available and the highest of the possible liability and cost amounts. Thus prudence determines the following:

- **assets** that are represented in the balance sheet of the period in question must be given the lowest of all possible assessment values;
- **costs** that were potentially incurred in the given reporting period are not attributed to future reporting periods but are recognised in the current reporting period;
- **liabilities** shown on the balance sheet of any given period must be given the highest of all possible assessment values;
- **revenue** that has been potentially gained during the current reporting period must be recognised in the same reporting period when it is realised.

Prudence can be applied in the distribution of certain amounts among several accounting items that are included in the balance sheet according to their net balance and to accounts reflecting the financial results. Accordingly the allocation of these results to the reporting periods is devised.

Matching / Accruals

In the income statement both revenue and expenditure is recognised at the moment of incurring (during the period when the economic benefits occur and the resources are consumed) and not when cash is paid. The matching principle is complied with as follows:

- recognition of the results of transactions after closing the transaction;
- recording of transactions in the period during which it has been executed;
- preparing the information about accounts payable and accounts receivable instead of preparing information only about the payments made and received;
- only such expenditure is recorded in the reporting period that earns revenue in the same period.

Therefore, prepayments and accruals are used in accounting.

Article 25 of the law 'On Annual Reports of Enterprises' says: '… 4) any revenues and expenses related to the accounting period shall be included in the income statement irrespective of their date of payment or receipt or issuance of the invoice. Revenue earned must be matched against the expenditure incurred in earning it in the respective accounting periods.'

IAS 1 – 'under the accruals basis, the effects of transactions and other events are recognised when they occur, and not as cash or its equivalent is received or paid. Expenses are recognised in the income statement based on the direct correlation between incurring of expenditure and an item of revenue earned (matching or consistency principle).'

Expenditure recognition: method of matching revenues with expenses

Matching of revenues with the expenses is the most important condition for recognition of expenditure and for their presentation in the income statement. In general, the following rule applies:

If expenditure incurred results in **future benefits**, it is presented as an asset;

If it results in **current** benefits – as an **expense**;

If it does not result in any benefits at all – as **losses**.

Expenditure is recognised in the income statement after recognition of the revenue earned as a result of this expenditure. For example, cost of goods sold is recognised as a cost in the income statement only after recognition of revenue from sale of the products.

If expenditure is a pre-condition for gaining of revenue over several reporting periods and the correlation between expenditure and revenue cannot be assessed with reasonable certainty or can be assessed as the best estimate only, expenses are recognised in the income statement by appropriately splitting between the periods.

An item is recognised as expense within the reporting period, if the respective item does not bring future benefits to an enterprise or if these future benefits do not correspond to the criteria that need to be met in order to present an asset in the balance sheet.

The practical application of the accruals principle leads to the necessity of making the estimates of the following nature:

1. ***Accruals:***
    - Accruing of expenses leading to creation of invoices to be paid – accounts payable (accrued expenses = accrued liabilities);
    - Accruing of revenues leading to creation of revenues receivable (accrued revenues = accrued assets).

2. ***Distribution of prepaid amounts:***
    - Distribution of expenses prepaid in the reporting period;
    - Distribution of deferred revenues received in the reporting period;

3. ***Estimated items:***
    - Accrued depreciation of fixed assets;
    - Accrued amounts for write-off of intangible assets;
    - Provisions for doubtful debts.

Consistency (constancy)

Changing from one reporting period to the next, the entity must apply the same accounting methods that were earlier opted for, to enable valid comparisons of the report data to be made over time.

Article 25 of the law 'On Annual Reports of Enterprises' says: '… 2) it is required to maintain the same evaluation methods that were used in the preceding reporting period.'

Going Concern

The accounting system must be established on the assumption that the entity is going to continue its operations for an unlimited period of time. Consequently, that the enterprise has neither the intention, nor the necessity of liquidation or of curtailing materially the scale of its operations.

This presupposes the following:

Assets of the enterprise should be presented according to their original value without the consideration of their 'break-up' value.

Otherwise, a statement of liquidation should be included in the reports in the following order:

- Evaluation of property must be made at its liquidation value;
- Assets that cannot be disposed of in full must be scrapped;
- Accruals for liabilities should include the option of contract termination and the possible economic sanctions.

Article 25 of the law 'On Annual Reports of Enterprises' says: '… 1) it is necessary to admit that the enterprise is a going concern'.

IAS 1: 'Upon preparing the financial statements the management must assess the capacity of the enterprise to continue its operations. Financial reports must be prepared with the view that the enterprise is a going concern, unless the management has any intentions or options for liquidation of the enterprise.'

2.6.2. Accounting principles

Apart for the four above mentioned underlying assumptions accounting is based on several generally accepted accounting principles, and they are as follows:

1) Separation of accounts
Material asset and liability items, revenues and expenses are presented separately. Accounts receivable and accounts payable must be evaluated separately and presented in the reports separately.
2) Business entity (independence)
An entity is an independent business unit and must be treated in accounting distinct from its owners by presenting the obligations towards the owners as shareholders' capital (equity).
3) Duality
An operating example of this principle is the balance sheet, while an example of its evolution is the double entry.
4) Money measurement
5) Original cost value
Usually all assets are included in accounts according to the value of their acquisition, i.e., at their original cost or historical cost.
6) Realisation
Income is recognised at the moment of goods delivery or provision of service. The moment when cash is received for the goods sold (services provided) may not coincide with the moment of recognition.
7) Materiality
Information is believed to be material (and therefore its presentation is deemed as necessary), if the availability of this information could be useful (material) to the users of financial statements.
An error is considered material by auditors, if it can influence the decisions taken by the users of financial statements.

Amount of profit before tax is the basic criterion for materiality. Total amount of errors in the financial statements exceeding 10 % is usually considered as material, while below 5 % - as immaterial.

The approximate criteria for assessment of materiality are shown below:

Criterion of assessment	***Minimum limit***	***Maximum limit***
Profit before tax	5%	10%
Current assets	5%	10%
Total assets	3%	6%
Short-term liabilities	5%	10%

Example: Profit before tax of Enterprise N constituted 10,000 lats in Year 2003. During the audit procedure of the enterprise profit calculation an error was discovered - expenses of 1,200 lats were omitted. Is this a material error?

2.6.3. Accounting methods and policies

Accounting methods are the practical realisation of the fundamental assumptions. The methods are more in number and they are more diverse than the assumptions as these reflect the large variety of business activities and economic realities.

Accounting policies are a set of accounting methods most suitable for the entity and adopted by the entity as the basis for preparing and presenting financial statements.

In other words, the management team chooses such accounting methods as it deems best for the situation of its entity and builds the accounting policy accordingly. Accounting policies, on their turn, establish the accounting principles, rules and guidelines of the relevant entity. So, the practical realisation of accounting directly depends on the accounting policy adopted. If the accounting policy changes, the financial reports, the income statement and the balance sheet are also changing.

International Financial Reporting Standard 1:

> Management shall select and apply the accounting policies in such a manner that the financial statements would correspond to all requirements of the applicable financial reporting standard.
>
> *Accounting policies* – the specific principles, guidelines, conventions, rules and procedures adopted by an enterprise in preparing and presenting financial statements.

Under the notes section of the financial statements the following information must be provided on accounting policies:

- valuation policy used in the preparation and presentation of financial statements;
- description of all accounting policies, if necessary to properly understand the financial reports.

The accounting policies that the enterprise may disclose are as follows:

- revenue recognition;
- basis for consolidation;
- enterprise mergers;
- joint ventures;
- recognition of tangible and intangible assets and their depreciation/write-off;
- capitalisation of the costs of borrowing and other expenditure;
- construction contracts;
- investment properties;
- financial instruments and other investments;
- leasing transactions;
- costs of research and development projects;
- inventories;
- taxation, deferred taxes;
- accrued charges;
- payments of employee benefits;
- foreign currency revaluation and hedging;
- basis for the distribution of business and geographical market segment costs;
- definition of the meaning of cash and cash equivalents;
- accounting for inflation;
- government grants.

Other disclosures

The enterprise must disclose the following:

- the country of incorporation and the legal form of the enterprise as well as its registration number and the official address;

- description of operations;
- the name of its mother company and the name of the top mother company of a concern;
- either the average number of employees of the reporting period or the exact number of employees at the end of the reporting period.

3. Preparation and Presentation of Financial Statements in Accordance with the Requirements of IFRS

3.1. Component elements of the financial statements

Composition of the forms of reports and the procedure of their preparation is established by IFRS 1 'Presentation of Financial Statements' according to which a full set of financial statements shall include:

- *The Balance Sheet*
  The balance sheet (balance sheet report) presents a set of balances of the assets owned by the enterprise and their sources, at the choice of the enterprise the balance sheet can be completed according to the British, American or Continental layout.
- *The Income Statement or the Profit and Loss Account*
  The income statement summarises all revenues and expenses according to the types of operations - transactions, other, extraordinary and discontinued. It is prepared in accordance with one of the two alternative layouts: expense format (by expense items) or the functional format (by functions of expenses) – at the choice of the entity.
- *Statement of Changes in Equity*
  Statement on capital movement summarises changes to the equity. The types of preparation of this report depend on the legal status of the enterprise.
- *Cash Flow Statement*
  This statement is prepared by using either the direct or the indirect method, on a cash basis, by grouping the items by the types of activity – operating, investing and financing activities. The enterprise specifies the composition of the types of activity by describing the items of the cash flow statement.
- Accounting Policies and Explanatory Notes

3.2. Balance sheet

IFRS 1 does not regulate the use of one single, exact balance sheet layout. In practice two layouts are conventionally applied as compared to two forms of accounting equation:

Net Assets = Capital

or

Assets = Equity + Liabilities

The standard states that '**each material item** should be disclosed **separately** in the financial report. Immaterial amounts shall be added to the amounts of a similar nature and meaning, and these must not be separately disclosed.'

The items under assets and liabilities, income and expense must not be off-set against each other and they should be separately disclosed in the reports, unless they are immaterial. Off-set is possible only in situations when:

- it is expressly permitted or even required to do so in the IFRS;
- the items are classified as immaterial.

The reporting period for financial reports is one calendar year. The opening date of any reporting period can be established on the first day of every month. Any reports made for each quarter or month, or any other time interval are considered as interim reports and are provided to users at the decision of the enterprise management for various reasons.

The standard lays down **the minimum information content** to be presented in the reports.

Table 3.1. Information content to be included in the reports

Balance sheet report	**Income statement**	**Statement of changes in equity**
Fixed assets; Intangible assets; Financial assets; Investment accounted for according to the equity interest method; Inventories; Minority interest share; Cash and cash equivalents; Trade and other accounts payable; Tax payable; Tax receivable; Provisions (liabilities); Long term loan interest payable; Trade and other accounts receivable; Equity; Reserves (equity).	Sales revenue; Operating results; Cost of financing; Share of profit/loss from associated companies and joint ventures accounted for according to the equity interest method; Taxation expenses; Profit/loss from ordinary activities; Extraordinary effects; Financial results due to the minority interest holders; Net profit/loss for the reporting period	Net profit/loss for the reporting period Revenues, expenses, profit or loss recognised in equity (dividends, share issue premiums, impairment, revaluation); Effects of changes in accounting policies; Effects of adjustments for fundamental errors.

An enterprise must disclose any of the above mentioned items either directly in the balance sheet report or under the explanatory notes of the report. The level of detail of the balance sheet items besides should present the substance of business activities of the enterprise, which is determined by the following:

- *The nature and liquidity of assets;*
- *Significance of asset information;*
- *Functions performed in the respective industry.*

The level of detail in the layout is determined by the principles of classification formulated in the relevant IFRS.

For example, fixed assets should be disclosed separately under real estate properties and fixed assets involved in production.

If assets are measured on different basis, depending on the conditions, for example, according to the original (historical) cost or replacement value, this should serve as sufficient grounds for disclosing them separately.

Financial assets are classified in debentures, bills of exchange or shares held in other companies. Inventories are classified as goods for sale, raw materials, work in progress, finished products; accounts receivable are split into trade receivables, advances and prepayments, settlements with related parties, short-term debts with the period of repayment in the following year.

The term for extinguishing or recovery of the items under balance sheet is the generally accepted basis for classification of these items, in other words - their circulation. An enterprise must separately disclose any amounts the repayment or recovery of which is expected within 12 months from the date of the report as well as after the 12 months' period from the date of report for each item that can be presented in a lump sum. Such classification allows the extraction of data for assessment of liquidity and solvency.

Short-term (current) assets have the three following characteristics in common:

- they will be turned over within a single normal cycle of operations;
- they are turned over within no more than 12 months from the date of report;
- they are not subject to restrictions in respect of the term of use as these are either cash assets or readily realisable elements.

All other assets must be classified as **non-current assets**.

Operating cycle is assumed to be the time period that elapses from the moment of purchase of any assets used in production and realisation (spending of cash assets on their purchase) till their sale in exchange for cash (cash equivalents) or other assets that are readily realisable into cash.

Liabilities are defined as short-term (current) if:

- they will be paid off in the normal course of trade of the enterprise;
- they will be liquidated within 12 months after the preparation date of the report.

In practice, a large number of balance sheets is prepared based on a structured classification. Assets must be presented in the balance sheet according to their degree of liquidity - from more liquid to less liquid assets, while the liabilities - by the dates of repayment. For example, it is possible to apply the following sequence of presentation of the balance sheet items:

Table 3.2.

Sample Balance Sheet
Structuring of items by reduced liquidity of assets and liability fulfilment dates

Assets	Liabilities
Cash and cash equivalents	Trade and other accounts payable (including with the repayment period of above 12 months from the reporting date)
Trade or other accounts receivable, including with the repayment period of above 12 months from the reporting date.	Tax payable (including with the repayment period of above 12 months from the reporting date)
Inventories	Long-term loan interest payable, including with the repayment date within 12 months from the reporting date
Financial assets (including with the recovery period of above 12 months from the reporting date)	Provisional liabilities (accruals) – for annual leaves, refurbishment, tax accruals (including with the repayment date within 12 months from the reporting date)
Intangible assets	Total liabilities
Fixed assets	Retained earnings and capital reserves

Total assets	Issued share capital, including the minority interest share Total capital Total liabilities and capital

Pursuant to IFRS 1 the following amounts included in the accounts receivable and the accounts payable items must be separately disclosed:

- from the holding company;
- from affiliated companies;
- from other related companies.

3.3. Income statement

Pursuant to IFRS 1 the following items must be included in the income statement:

- sales revenue;
- operating results;
- cost of financing;
- share of profit/loss from associated companies and joint ventures accounted for according to the equity interest method;
- taxation expenses;
- profit/loss from ordinary activities;
- results from extraordinary effects;
- minority interest share;
- net profit or loss for the reporting period.

Operating profit – profit from operations, the margin of revenue after operating costs.
Operating expenses – expenses incurred in operations which have not been included in the prime cost of production, but are necessary in the normal course of business, including sales and distribution, general and administrative expenses.

Two forms of income statement presentation:

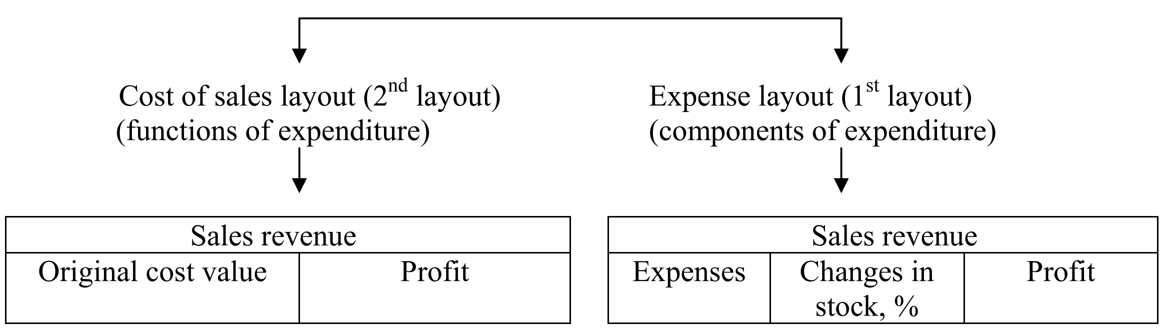


Chart 3.1. Two layouts of income statement presentation

Both layouts provide identical results, but as it may be seen from the chart they display the data for arriving at the financial results in a different way. The details of both layouts are illustrated below:

Table 3.3.

Table of comparison of two income statement layouts (general view)

FIRST LAYOUT SECOND LAYOUT

Sales revenue (+)	1680	Sales revenue (+)	1680
Production costs: - raw materials (-) - salaries (-) - depreciation (-)	 500 600 100	Production cost of goods sold (-)	850
Changes in stock of finished products and work in progress: At the beginning of the year (-) At the end of the year (+)	 250 320	Administrative expenses (-)	270
Other expenses (-)	120	Sales and distribution costs (-)	130
Operating profit	+430	Operating profit	+430
Other income and profit (+)	150	Other income and profit (+)	150
Other expenses and losses (-)	280	Other expenses and losses (-)	280
Profit before tax	+300	Profit before tax	+300
Income tax	100	Income tax	100
Net profit	200	Net profit	200
Dividends	(100)	Dividends	(100)
Retained earnings	100	Retained earnings	100

Other income and expenses are income and expense items directly not attributable to sales transactions:

- income from interest in other enterprises and other long-term investment: dividends, share of profit from memberships, interest from loans issued, interest from debentures, etc.;
- other interest income and expenditure: interest on deposits with banks, other liabilities and bills of exchange, exchange differences, security agios and disagios, etc.;
- cash and security investments written off;
- interest paid and other payments.

The standard requires the disclosure in the income statement or the explanatory notes the payment of dividends or dividend proposals per share.

Table 3.4.

Layouts of the Income Statement

Functional layout **Expense layout**

1. Net sales	X	1. Net sales	X
2. Cost of sales (services)	(X)	2. Other operating income	X
Gross profit (loss)	X, (X)	3. Changes in stock of finished products and work in progress	X, (X)
3. Other operating income	X	3. Cost of raw materials for production	(X)
4. Sales and distribution costs	(X)	4. Prime cost of production services	(X)
5. Administrative expenses	(X)	5. Salaries to production personnel	(X)
6. Other operating expenses	(X)	6. Social expenses (by separately disclosing deductions to pension funds)	(X)
		7. Tangible and intangible production asset write-offs	(X)

		8. Other operating expenses	(X)
Operating profit (loss)	X, (X)	**Operating profit (loss)**	X, (X)
Income from subordinated entities			X
Income from other investment and loans			X
Interest and similar income (financial income)			X
Interest and similar expenditure (financial expenditure)			(X)
Profit (loss) before taxes			X, (X)
Income tax expense			(X)
Profit (loss) from ordinary activities after income tax			X, (X)
Unexpected (extraordinary) income			X
Unexpected (extraordinary) expense			(X)
Income tax			(X)
Other taxes			(X)
Net profit (loss) for the period reported			X, (X)

The titles of the items under income statement, their amount may vary depending on the nature of enterprise operations as well as on establishing of certain and comprehensive information about the financial results for the purpose of presentation.

3.4. Statement of changes in equity

Changes in equity may occur due to the following reasons:

- disbursement of dividends to owners and share issues;
- profit or loss not recognisable in the income statement;
- accumulated (retained) earnings;
- changes in accounting policies.

Pursuant to IFRS 1 the enterprise must perform the presentation of a separate form of financial statements disclosing the following:

- Net profit or loss for the period;
- Each item of income and expense, profit and loss which is recognised in the equity following the requirements of other standards as well as the total amount of these items;
- The effect made by any changes in accounting policies and adjustments due to the correction of fundamental errors (according to IFRS 8);
- capital transactions with the shareholders and the distribution of profit to owners;
- Retained earnings or net loss at the beginning of period, as of the reporting date and the amount of change during the period;
- Comparison of the book value of each share capital item, gain from emission of shares and each reserve at the beginning and end of period by separately disclosing each change.

For an expanded format on changes in equity usually the column format is used where each component item has a separate column (Table 5):

Table 3.5.

An example of summary of changes in equity

	Share capital	Gain from issue	Revaluation fund	Others	Accumulated earnings	Total
Net balance at the beginning of period	X	X	X	(X)	X	X
Changes in accounting policies					(X)	(X)
Re-valued net balance	X	X	X	(X)	X	X
Asset revaluation amount (increase/decrease)			X (X)			**X**
Investment revaluation amount (increase/decrease)			X (X)			**(X)**
Currency revaluation difference* (increase/decrease)				X (X)		(X)
Total profit and loss not recognised in the income statement			X	(X)		X
Net profit for the reporting period**					X	X
Dividends paid					(X)	(X)
Share issue	X	X				
Net balance at the end of period	X	X	X	(X)	X	X

* The difference from currency revaluation occurs in the free (consolidated) report by summarising the reports prepared in another currency than the currency of the consolidated report, i.e., from foreign affiliates of the enterprise.
** Net profit or loss for the reporting year is the final figure from the income statement for the same period.

Sample forms of this statement are not the only forms that can be used. These samples are only given to illustrate the possible statement versions.

Table 3.6. Sample summary statement on changes in equity

	Year reported	Previous year
Surplus (deficit) from revaluation of assets	X	(X)
Surplus (deficit) from revaluation of investments	(X)	X
Currency differences due to revaluation of financial statements prepared in other currencies	<u>(X)</u>	<u>(X)</u>
Profit not recognised in the income statement	X	X
Net profit for the reporting period	<u>X</u>	<u>X</u>
Total effect of recognised income and loss on changes in capital	X	X
Effect of changes in accounting policies		(X)

3.5. Explanatory notes to the financial statements

Component elements of the explanatory notes:

- Statement about preparation of reports in accordance with the requirements of IFRS.

- Description of accounting policies in which (at least) the methods of measurement (bases) used must be established and the selected accounting principles for the following component items described:

    - Revenue recognition;
    - Basis for consolidation;
    - Recognition of the tangible and intangible asset write-offs;
    - Capitalisation of financial and other expenses;
    - Construction contracts;
    - Investment properties;
    - Financial instruments and investments;
    - Leasing transactions;
    - Research and development costs;
    - Inventories;
    - Taxation, including deferred taxes;
    - Reserves;
    - Labour remuneration expenses;
    - Expenses under pension schemes;
    - Foreign currency transactions and exchange differences;
    - Overview of business (entrepreneurial activities) and the geographical segments covered;
    - Accounting for inflation;
    - Government grants.

- Disclosure of the items included in the main sections of the financial statements as required by the particular business situation and the principles of disclosure of the information outlined in the appropriate standards.

- Other additional information, including non-financial data, which at the opinion of the author of the financial statements could be of use to the their users.

3.6. Audit opinion

Some companies must enclose the auditors' opinion with the financial statements.

The objective of the auditors is to provide confidence to the users of financial statements that these financial statements present a true and fair view of the company financial position as of a certain date and to inform about how the company reached such a position. Auditors provide an opinion concerning the degree of faithfulness of the information contained in the financial statements.

The following information must be included in the auditors' opinion:

- Reference to the compliance of the financial statements with the generally accepted accounting principles;

- If there are any deviations form the generally accepted accounting principles, the reasons for such deviations must be stated;
- Reference to the completeness of the information provided;
- Opinion on the financial statements in general or the reasons due to which the opinion cannot be given.

3.7. Foreign currency transactions and effects of changes in foreign exchange rates 21. Application of IFRS 21

This standard is applied in accounting for the transactions executed in foreign currencies and for translating the financial statements of foreign operations.
This standard regulates the following principal issues:

- to determine which exchange rates to use for financial records and for revaluation;
- how to recognise the effects of changes in exchange rates in the financial statements.

Local (Domestic) Currency: Currency used in the environment in which the enterprise is functioning, which subject to the state legislation is the currency for presentation of the annual report and the tax reports.

Reporting Currency: Often identical with the local currency, but may also be a different currency; the currency of preparation and presentation of the report.

Foreign Currency: Other than the reporting currency.

Historic Rate: The rate of recording a transaction in the accounting records.

Currency Exchange Difference: Occurs when presenting an identical number of foreign currency units in the reporting currency by using different exchange rates.
Closing Rate: The exchange rate of present transactions at the balance sheet date.

Monetary Items: Cash held, assets to be received or liabilities to be paid in fixed or determined amounts of cash.
Fair Value: The amount for which an item of assets could be exchanged or an item of liabilities settled between knowledgeable, willing and independent parties in an arm's length transaction.

The standards define two essentially different cases where the necessity arises to address the currency translation issues:

- transactions in foreign currencies;
- preparation and presentation of financial statements for foreign operations or foreign entities.

Foreign currency transactions refer to the issue of preparing and presenting the financial statements of an entity in line with the local legislation requirements.

Preparation of financial statements for foreign operations or foreign entities is a part of the process for preparing of consolidated financial statements when the reports of subsidiaries (based in other countries) which are prepared in foreign currencies must be included in the consolidated report of the parent company. This issue arises at the end of the reporting period when preparing the consolidated report.

The main concerns arising in both situations are as follows:

- What exchange rates must be used for foreign currency translation?
- How the exchange differences (gains/losses) resulting from the translation must be recognised?

Foreign currency transactions

<u>Initial recognition</u>
Transactions in foreign currencies should be recorded at the rate of exchange existing at the date of the transaction (*the spot rate*) – at a historic rate.

<u>Measurement at the report date</u>

- Foreign currency monetary items must be recorded using the closing rate;
- Foreign currency non-monetary items recorded at the actual purchase cost must be presented using the exchange rate at the date of the transaction (*the spot rate*);
- Foreign currency non-monetary items recorded at fair value should be presented based on the rates that existed at the moment when the fair values were determined.

<u>Exchange differences</u>
Exchange differences arising when monetary items are settled or when monetary items are presented in the financial statements of the enterprise at rates different from those at which they were translated when initially recognised or in previous financial statements are recognised as profit or loss in the period when arising.

Exchange differences arising on monetary items, that form part of investment in a foreign subsidiary, must be classified in the financial statements as equity until the moment of disposal of the investment, after which they will be recognised as income or expense in the period when either profit or loss on disposal of such investment is recognised.

Exchange differences can arise in the result of a fall in the exchange rate or devaluation of a currency (in which the accounts payable items related to asset acquisitions, invoices outstanding at the end of period are denominated). In this situation **an alternative approach** is used. Exchange differences arising from the re-valuation of accounts payable must be included in the value of assets (on the condition that the value of assets does not exceed either their replacement value or recoverable value on use or disposal of the asset item in question). *Thus it is provided that the value of assets constitutes an amount in the reporting currency that will be paid at the closing of the settlement (by extinguishing the liability which was incurred as a result of purchasing the asset item).* If however the enterprise is in the position of closing the settlement and hedging the exchange differences on payables, such differences may not be included in the value of assets.

The examples given below illustrate the application of this alternative approach.

Example 1
A Latvian enterprise obtained a long-term loan in the amount of USD 150,000 from the bank, which it invested entirely in the statutory capital of a foreign enterprise. The Bank of Latvia dollar rate at the date of issuing the loan was 0.55.
At the end of the reporting period the dollar rate had grown to 0.552.
Required:

1) Measure the amount of financial investment as well as the amount of debt at the moment of borrowing and investing;
2) Measure the amount of debt at the end of the reporting period;

3) Present the amount of exchange difference in the financial statements.

Example 2
Purchase of production equipment for USD 380,000 has been paid by using a credit facility at the Bank of Latvia rate of 0.55. The dollar rate at the moment of preparing the financial report was 0.56. The fair value of the equipment at the report date was LVL 211,000.
Required:
1) Measure the amount of debt at the moment of purchase of the equipment and at the end of the reporting period.
2) Calculate the exchange difference and present it in the financial statements.

Financial reports on foreign operation

The method used for translating the financial statements for foreign operation depends on the financing of this operation as well as on the type of performing this operation. For such purposes foreign operation is classified as follows:
- as foreign operations constituting an integral part (subsidiary or branch) of the enterprise operations;
- foreign entities.

In the first case an integrated foreign company is involved constituting an inseparable part of the enterprise (accounting is centrally at the enterprise), and therefore any changes in exchange differences rather affect some individual balance sheet items of the enterprise than the enterprise's net investment.

In the second case the foreign entity itself carries out its business management. Any changes in exchange differences rather affect the net investment of the enterprise in the foreign entity than some individual balance sheet items.

By translating the data of foreign entities the exchange differences are reported in the line 'Capital' (foreign currency re-valuation reserve) until the moment of disposal of the investment, as the exchange differences do not affect the present and future cash flows, and do not affect the cash flows of the parent company either.

The financial statements of foreign entities are translated using the closing rate.

Several characteristic features exist by to which a foreign operation can rather be classified as foreign entity than foreign operations constituting integral part of the enterprise:
- certain autonomy exists in performing the operations irrespective of the control exercised by the enterprise;
- transactions carried out between the foreign entity and the enterprise do not constitute the major part of the enterprise operations;
- foreign entity is largely financing its operations independently or via local loans;
- acquisition of assets and payment for production costs is performed in the local instead of the reporting currency.

The time method requires the use of the following rates:

Item	**Translation rate**
Value and depreciation of property, plant and equipment and intangible assets	At the rate existing on acquisition date
Inventories	At the average rate for the purchase period
Monetary (cash) assets	At the rate existing at the report date
Revenues and expenses	At the average rate for the reporting period
Exchange differences	Recorded as revenue/expense

Example 3

An English Corporation X owns 100% of shares in a foreign company ABC Ltd. The local currency for ABC Ltd. is CU. (conditional). On January 1, 2003, the issued capital was 50,000 pounds with the exchange rate of 12 CU against the pound.

On January 1, 2003 ABC took a long-term loan of 200,000 CU and immediately purchased equipment for 700,000 CU with the expected useful life of 10 years with evenly accumulated depreciation.

Below the financial statements of ABC are given in local currency for the year 2003 as well as the relevant exchange rates in the year 2003.

Required:

Translate the financial statements of ABC Ltd. using the time method and establish the exchange difference in accordance with IFRS 21.

	CU/pound
As of January 1	12
Average rate for the year	11
Average rate for the period of purchasing inventories	10.5
31. As of December 31	10

Company ABC
Income Statement
for the reporting period ended 31.12.2003

	Thous. CU
Sales revenue	900
Less Cost of goods sold	(720)
Gross profit	180
Less Depreciation	(70)
Other expenses	(30)
Net profit	80 ====

Company ABC
Balance Sheet as of 31.12.2003

	Thous. CU
Share capital	600
Retained earnings	80 680 ====
Equipment	700
Less Depreciation	(70) 630
Inventories	210
Cash assets	40 880
Less Long-term loan	(200) 680 ====
Amount of exchange difference	

4. Accounting for long-term investments IFRS 16 'FIXED ASSETS'

4.1. Definitions
4.2. Criteria of recognition
4.2.1. Criteria of recognition
    4.2.2. Initial measurement
    4.2.3. Subsequent measurement of fixed assets
4.3. Withdrawal from operations and disposal
4.4. Impairment of asset value
4.5. Amortisation
    4.5.1. Estimated useful life of the fixed asset items
    4.5.2. Depreciation methods
4.6. Disclosure of information in reporting
4.7. Main provisions of IFRS 16
4.8. Practical exercises

The principal issues in accounting for fixed assets are as follows:
- *moment of asset recognition;*
- *establishing the book value of assets;*
- *establishing the procedure for depreciation;*
- *disclosure of information.*

4.1. DEFINITIONS

Fixed assets – material assets, which:
→ used by the enterprise in production, goods delivery, provision of services, leasing out or administrative purposes; and
→ are intended for use over several accounting periods.
The following are samples of separate asset **groups**:
- land;
- objects of territorial infrastructure development;
- constructions;
- plant and equipment.

Depreciation – reduction on a systematic basis of the depreciable value of a asset over the entire estimated useful life.

Depreciable amount – the initial (or re-valued) value of fixed assets, less the estimated residual value.

Residual value – net amount the enterprise expects to gain on disposal of an asset at the end of its estimated useful life, less any expected costs of withdrawal from operation.

Historical cost – an amount of cash or cash equivalents paid or other consideration given in exchange for acquisition or construction of an asset.

Fair value – the amount for which an item of assets could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Carrying (book) value – the amount at which an item of assets is recognised in the balance sheet, less accumulated depreciation and losses due to value impairment.

Impairment loss – amount by which the carrying value of assets exceed their recoverable value.

Recoverable value – the higher of the two following amounts: the net realisable value of an asset and its value in use. Recoverable value - the amount offered as a consideration in the future use of an asset, including its residual value on disposal. The carrying value should be periodically reconciled to the recoverable amount.

Value in use – the discounted present value of the future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Net realisable (selling) value of an asset – fair value of an asset less costs to sell.

4.2. Recognition criteria

4.2.1. Criteria of recognition

- a probability exists that any future economic benefits associated with the use of assets will flow into the enterprise;
- the value of an asset of the enterprise can be reliably measured.

Comments on the concept of recognition:

- a relatively high probability that the asset will bring future economic benefits only occurs when ***the benefits and the risks*** are owned by the enterprise (until then the transaction for the acquisition of an asset may be cancelled usually without any significant sanctions being imposed and therefore the asset is not yet recognised).

- in cases when ***the composite parts*** of the asset item in question has different estimated useful life terms or when the benefits from the individual parts are gained under different patterns requiring the use of different rates and methods of depreciation, the total amount of costs incurred by the asset must be broken down into the amounts corresponding to the composite parts and carried separately in the books;

- any fixed assets acquired for the purposes of ecological safety and protection of environment do not, of course, carry any economic benefits by themselves, however, they help to gain additional benefits from other material assets under the possession of the enterprise. Therefore, these assets can be recognised and reported as fixed assets, but only in case if their purchase cost is compensated by the sales revenue of the respective products.

4.2.2. Initial measurement

An item of fixed assets which qualifies for recognition as an asset should initially be measured at its cost.

The following components are included in the cost of items **acquired as fixed assets**:

- their purchase price (less any trade discount), import duties, non-refundable purchase taxes;

- costs attributable to bringing the asset to working condition for its intended use (the cost of site preparation, initial delivery and handling costs, installation costs, professional fees, expected dismantling costs, asset disposal and site renovation costs – as long as these costs are recognised under provisions (pursuant to IFRS 37);

- administrative and other general overheads are not the components of the cost of fixed assets, unless these costs are not directly attributable to acquisition of the asset or its preparation for use.

Self-constructed assets can be measured based on the same principles that are applied to acquired assets. The cost of self-constructed assets must be measured exclusive of any internal profit made. Any abnormal costs of wasted material, labour or other resources incurred in the construction of an asset are not included in the cost. IFRS 23 outlines the terms for inclusion of interest payments in the cost of a fixed asset.

The initial cost of an item obtained **through (part)exchange** equals the fair value of the asset transferred, which is adjusted by the amount of cash or cash equivalents transferred (received) in the process of exchange.

In the case of disposal of **a project of unfinished construction** the costs capitalised must be written off to expenses.

Subsequent costs:

→ the expenditure should be **capitalised** only when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will be gained (‘upgrading and improvement’);

→ the expenditure intended for the maintenance of the asset over its estimated useful life **are not capitalised and are written off as an expense in the current period** (‘restoration or maintenance of economic benefits’).

4.2.3. Subsequent measurement of fixed assets

<u>Benchmark treatment:</u>
Subsequent to initial recognition as an asset, an item of fixed assets should be carried at its cost less any accumulated depreciation and losses due to impairment in value.

<u>Allowed alternative approach:</u>
Subsequent to initial recognition as an asset, an item of fixed assets should be carried at a re-valued amount, being its fair value at the date of the re-valuation less any subsequent accumulated depreciation and losses due to impairment in value. Re-valuations should be made with sufficient regularity such that the carrying amount does not differ materially from its fair value at the balance sheet date.

Re-valuation

The new fair value is the market value and it should be determined based on **expert measurement** (being the opinion of special firms - the independent property valuers).

When an item of fixed assets is re-valued, it is necessary to re-value the rest of the fixed asset items **of the same class** (it is not required to do it at the same time, but within a limited time interval).

When carrying out the re-valuation of an item of fixed assets, **the amount of depreciation accumulated** at the re-valuation date is re-assessed in proportion to the amount of change in the carrying value of the fixed asset before depreciation so that after re-valuation the carrying value of the item equals to the re-valued amount. This method is often used when an item of assets is re-valued **through indexing** to its recoverable amount, by taking account of depreciation.

If an item of fixed assets is re-valued **upwards**, the amount of increase must be credited to equity – 'revaluation reserve' (however, only in case if the previous re-valuation losses have not been reported in the income statement).

If an item of fixed assets is re-valued **downwards**, the income for the reporting period must be reduced by the same amount (the respective amount is reported in the income statement, but only in case if the previous gains re-valuation gains from this asset has not been reported under 'revaluation reserves').

The positive effect from re-valuation included under the balance sheet item of 'Capital' can be written off directly in the retained earnings account upon realisation as follows:

- the entire amount can be realised when the item of assets is withdrawn from operation;
- a part of this amount can be realised already in the process of use of the asset. In this case the amount of the positive re-valuation effect will equal the amount of difference between the amount of depreciation calculated based on the re-valued carrying amount of the asset and the amount of depreciation calculated based on the initial value of the asset. The amount of the positive effect from re-valuation written off to the retained earnings account is not presented in the income statement.

4.3. Withdrawal from operations and disposal

→ An item of fixed assets should be eliminated from the balance sheet on disposal or when the decision on discontinuation of the use of asset is taken and no future economic benefits are expected on disposal of the asset.
→ In case of disposal or write-off of an item of fixed assets the remaining value is written off from the balance sheet.
→ Besides any gains or losses arising from the retirement or disposal of an item of fixed assets should be determined as the difference between the estimated net disposal proceeds and the carrying amount of the asset. It is recognised as an income or expense in the income statement. (It is possible to offset any amount of losses, in part or entirely, with the any amount of 'increase' arising from asset re-valuation held under the item of 'revaluation reserve',
if it is expected that large costs will be incurred by the enterprise on disposal of the item of fixed assets (by reducing the amount of disposal or by presenting such costs as a permanent balance sheet item in order to fully clear the liabilities incurred by such costs at the end of the term).
→ Fixed assets the use of which is discontinued and intended for disposal are recorded at their carrying value as of the date of withdrawal.

4.4. Impairment of fixed assets (IFRS 36)

At least once a year, at the end of each financial year, enterprises should test their assets for impairment (pursuant to IFRS 36) and recognise the impairment losses.

Should any indications exist evidencing an impairment in value, the enterprise must at least look at ***the external sources of information*** (*the market value of an asset item has declined significantly more during the period than could have been expected in the normal course of business; significant changes have occurred in the technological, market, economical or legal conditions; the interest rates have grown in the market; the carrying amount of the enterprise net assets has grown larger than its share of market capitalisation*) and **the internal sources of information** (*there is an indication that the asset has become obsolete or physically damaged; changes have occurred in the financial position of the enterprise affecting the rate or type of the asset use – discontinuation or closure of the operation in which the asset was used*).

The carrying amount should be reduced to the recoverable amount of the asset value only when the recoverable amount is less than the carrying amount. This amount of decrease constitutes the impairment loss.

Impairment losses should be immediately recognised as an expense in the income statement except in cases when the asset is recorded at the revalued amount. In this situation the impairment loss of the asset is recognised at once as a decrease in equity added due to re-valuation of assets as long as the amount of the impairment loss does not exceed the value of equity added due to revaluation of the same asset.

After recognition of the impairment loss the amount of depreciation in future periods must be adjusted, taking into account the change in the gross carrying amount of the asset.

At each balance sheet date the enterprise must assess whether there is an indication that the impairment loss recognised in previous years may no more exist or have decreased. If so, the recovery of the impairment loss should be recognised.

The amount of increase due to recovery of the impairment loss may not exceed the carrying amount measured (excluding depreciation) before any procedure for recognition of the impairment loss was undertaken. The amount of increase in above this amount means that the asset has been excessively revalued. Recovery for impairment losses is recognised in the income statement as income as long as it was previously recognised as a loss of the same asset item. After the equity account is credited for the amount of effect due to revaluation.

4.5. Amortisation

4.5.1. Estimated useful life of the fixed asset items

→ Laid down by the enterprise management *(groups of the same type of fixed asset items, while also permitted for single asset items)* based on their usefulness to the enterprise in question, and is:

- period of time during which the enterprise intends to use the assets; or
- number of output items or similar products that the enterprise expects to gain from the asset.

→ Established for all fixed assets, with the exception of **land**, as the allocation of the amounts intended for the write-off of an item of fixed assets (defined as the difference between the purchase price of a fixed asset item and the estimated residual value) over its useful life.

→ Depreciation deductions for the reporting period must either be recognised as the constituent items of direct or indirect production overheads (and included in the prime cost of the production) or as the constituent items of general business expenses (and in this case they are attributable to the period expenses).

→ 16. Under IFRS 16 some non-depreciable items of fixed assets are allowed, if such items have a very long period of useful life, the costs for the maintenance of their operating capacity are high, while the residual value in fact is not less than the current carrying value.

4.5.2. Depreciation methods

→ The depreciation method used should reflect the pattern in which the assets economic benefits are consumed by the enterprise;
→ Several alternative depreciation methods are allowed (at the choice of the enterprise);
→ The following methods are allowed:

- Straight line method;

- Reducing balance method;
- asset productivity method.

→ The useful life of an asset should be periodically reviewed. Not only the physical wear-and-tear factors, but also the factors of moral obsolescence (technology changes, fluctuation in market demand levels, etc.) as well as the policy of asset management - repairs and maintenance, should be taken into account.
→ The method selected must be applied consistently from one period to the next. The fact and the necessity of changing depreciation methods should be disclosed in the statements:
→ Upon revaluing the carrying amount the residual value must be adjusted with each revaluation.

4.6. Disclosure of information in reporting

For each group of assets the following must be disclosed:
→ method of measuring the gross carrying amount (listing of component parts and basis for measurement);
→ depreciation methods used;
→ applicable useful lives (or depreciation rates);
→ gross carrying amount and accumulated depreciation (including the accumulated impairment losses) as of the beginning and end of the year;
→ reconciliation of the carrying amount at the beginning and at the end of the year, showing:
* *additions* (including additions to value);
* *disposals* (including partial de-recognition),
* *acquisitions through enterprise mergers;*
* *revaluation increases or decreases as a result of re-valuation or impairment losses, which were recognised or compensated for directly in the equity account;*
* *impairment losses recognised in the income statement;*
* *reversals of impairment losses through the income statement;*
* *depreciation;*
* *net foreign exchange differences on translations of foreign entity financial statements* (into the currency of the parent company – pursuant to IFRS 21),
* *other movements*.

For items stated at re-valued amounts:
→ the asset revaluation method used;
→ the effective date of revaluation;
→ whether an independent valuer was involved;
→ the description of indices used for measuring the recoverable amount;
→ for each revalued class of assets, the carrying amount that would have been recognised had the assets been carried under the cost model;
→ the revaluation surplus for the period and any restrictions existing on the distribution of the balance of the reserve to the shareholders.

4.7. Main provisions of IFRS 16 (as at May of 2003)

RECOGNITION CRITERIA	IFRS
**** property title***	*Optional* (‘the enterprise uses…’)
**** threshold of measure***	Not specified (‘used over several accounting periods’)
INITIAL MEASUREMENT	
**** acquisition (purchase) and construction of asset items*** **→ capitalisation of loan %** **→ amount differences** **irrational expenses incurred in construction of a fixed asset item**	*According to the amount of the actual cost* – any rational expenses for bringing an asset to a working condition are added to the acquisition cost. *Basic recommendation* – any interest expense should be attributed to period expenses; *possible alternative procedure* – capitalisation of any loan interest amounts for qualified fixed asset items in the period when incurred, as provided in IFRS 23. *Losses due to exchange differences can be included in the carrying amount of fixed assets in extraordinary circumstances.* Not included in the carrying amount.
**** acquisition of an item of fixed assets in exchange for other fixed asset items***	At the market value of the transferred item.
**** acquisition of a fixed asset item as investment into equity***	At the actual cost amount.
SUBSEQUENT COSTS	
**** criteria for recognition of an increase in the value of a fixed asset item (subsequent cost capitalisation)***	It is probable that future economic benefits, in excess of the originally assessed standard of performance, will be gained (‘**upgrading and improvement**’).
REVALUATION	
**** regulations, restrictions***	*Benchmark treatment:* Subsequent to initial recognition as an asset, an item of fixed assets should be carried at its cost less any accumulated depreciation and losses due to impairment in value. *Alternative treatment:* periodical revaluation in accordance with the changes in fair value. All items of the same class are subject to revaluation.
**** presentation of revaluation in accounts***	*If there is an increase in value* – an offset of a previous loss in the income statement should first be made, and

	only then - recognition in equity. *If there is a decrease in value* – a reduction to a previously made revaluation surplus in equity should be made, and only then – recognition in the income statement of the remaining amount of the decrease.
**** realisation of 'equity revaluation surplus' – transformation into the retained earnings of the enterprise***	*Possible only* upon withdrawal of an item of fixed assets from use, but this can be carried out in parts - the amount of the annually realised positive re-valuation effect equals the amount of difference between the amount of depreciation calculated based on the re-valued carrying amount of the asset and the amount of depreciation calculated based on the initial value of the asset.
IMPAIRMENT	
**** regulations, restrictions***	*Principally significant procedure* for which a special regulation and accounting treatment is given in IFRS 36.
DEPRECIATION	
**** Base (depreciable amount)***	*Cost less residual value*
**** Opening and closing date of depreciation accumulation***	*Not specified*
**** List of fixed asset items exempt from depreciation***	*Land and other items in respect of which the consumer patterns are constant with time*
**** Possibility for review of the method of depreciation***	*Recommended* along with changes in the pattern of gaining future economic benefits from the asset use.
**** Possibility for review of the useful life***	*Recommended* along with the changes in the terms of use of the asset and its 'usefulness' for the enterprise.
**** Depreciation methods***	*Four methods* are described: * straight-line; * reducing balance; * sum of the digits; * asset productivity method.

4.8. Practical exercises

Exercise 1

Name the possible types of expenses that need to be recognised when determining the original purchase value of the following items of fixed assets in accordance with IFRS 16:

Fixed asset item	Expenses
Land	

Units of territorial infrastructure development	
Building	
Production equipment	

Exercise 2

Estimate the depreciation accumulation schedule over the entire useful life of a fixed asset item, using the depreciation methods recommended in IFRS 16 on the following conditions:

- initial cost of the fixed asset item - Ls 20,000;
- residual value – Ls 2,000;
- useful life – 5 years;
- The following amount of output is planned from the asset: 1. Year 1 – 2,500 units; Year 2 – 2,800 units;
  3. Year 3 – 1,900 units; Year 4 – 1,700 units; Year 5 – 1,100 units.
- Estimate the amount of depreciation according to the reducing balance method, use a double rate of depreciation.

Please enter your depreciation estimates in the table below.

Year	Straight line method	Proportional output of units method	Reducing balance method
1			
2			
3			
4			
5			
Total			

Exercise 3

1) Outline the qualitative characteristics of the costs attributable to *current repairing costs* and *capital expenditure*.

Current repairs	Capital expenditure
Objective of repairs - Extent and frequency of costs - The following accounts are debited - Example -	Objective of repairs - Extent and frequency of costs - The following accounts are debited - Example -

2) Describe the transactions and make the accounting entries of the following transactions: Enterprise A spent cash in the amount of 52 lats for small repairs (replacement of oil and ignition switches for a bus); and for Ls 2,000 re-modelled a car into a small van for food transportation.

Exercise 4

In Year 2003 Firm N sold a vehicle which has been purchased three years earlier for Ls 4,000. The purchase cost of the vehicle was Ls 9,600; the accumulated depreciation amount as of the moment of disposal was Ls 5,760.

You are required to:

1) Make the necessary accounting entries.
2) Prepare the 'Disposal of vehicles' account and establish the financial effect of disposal of the vehicle.

Exercise 5 Asset exchange transactions

On September 30, 2009 Enterprise XX exchanged an old item of machinery for similar new production equipment by paying an extra amount of 8,000 lats. The old machinery was purchased on January 1, 2007 for 28,000 lats. The useful life of the item of machinery was 5 years. Residual value – 4,000 lats. Depreciation has been accumulated for the old machinery item for a period ended December 31, 2008. The fair value of the old machinery item was Ls 12,000 as of September 30, 2009.

You are required to:

1) Perform the necessary depreciation estimates.
2) Make the necessary journal entries presenting the transactions performed by Enterprise XX in Year 2009 as of the end of the reporting period ended 31 December. Assume that the enterprise uses the straight-line method of depreciation.

5. Accounting for long-term investments IFRS 17 'LEASES’

IFRS 17 must be applied in accounting for all lease transactions with the following exceptions:
- Lease agreements entered into for the purposes of exploring or consumption of such natural resources as, for example, oil, gas, timber, metals and other minerals;
- licensing agreements for films, videos, plays, manuscripts, patents and copyrights.

5.1. Definitions

Lease transaction is an agreement under which the lessor transfers the right of use of a specific asset to the lessee for a definite period of time in exchange for a payment or multiple payments.

A lease transaction is classified as **a finance lease transaction** if it transfers substantially all the risks and rewards incident to ownership of the asset. The title may or may not be eventually transferred.

All other lease transactions are classified as **operating lease transactions**.

Non-cancellable lease transactions are leases that can be cancelled only:
- upon the occurrence of some remote contingency;
- with the permission of the lessor;
- if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
- upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The inception date of the lease is the earlier of the following dates: the date of the lease agreement or the date of a commitment by the parties to the principal provisions of the lease.
The lease term is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise
Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:
- in the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
- in the case of the lessor, any residual value guaranteed to the lessor by either:
  - the lessee;
  - a party related to the lessee; or
  - an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise the minimum payments payable over the lease term and the payment required to exercise this purchase option.

Fair Value: The amount for which an item of assets could be exchanged or an item of liabilities settled between knowledgeable, willing and independent parties in an arm's length transaction.

Economic life is:

- either the period over which an asset is expected to be economically usable by one or more users; or
- the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the beginning of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the enterprise

Guaranteed residual value is:

- in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and
- in the case of the lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Unearned finance income is the difference between:

- the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor; and
- the present value of the first item of this definition, at the interest rate implicit in the lease.

Net investment in the lease is the gross investment in the lease less unearned finance income.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, determines the following:

- the minimum lease payment;
- that the unguaranteed residual value should be equal to the fair value of the leased asset.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease. If such interest rate is not determinable, then it is the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

5.2. Classification of lease transactions

Lease transactions are classified as follows:

- Finance lease,
- Operating lease.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership to the lessee. A lease is classified as a operating lease if it does not transfer substantially all the risks and rewards incident to ownership to the lessee.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations which would normally lead to a lease being classified as a finance lease are:

1. The lease transfers ownership of the asset to the lessee by the end of the lease term;
2. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
3. The lease term is for the major part of the economic life of the asset even if title is not transferred;
4. At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
5. The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

1. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
2. Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
3. The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

Leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets.

Finance leases

Lessees should recognise finance leases as assets and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments. In calculating the present value of the minimum lease payments the discount factor is the interest rate implicit in the lease, if this is practicable to determine. If not, the lessee's incremental borrowing rate should be used.

It is appropriate to recognise a finance lease in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets. If for the presentation of liabilities on the face of the balance sheet a distinction is made between current and non-current liabilities, the same distinction is made for lease liabilities.

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

A finance lease gives rise to a depreciation expense for depreciable assets as well as a finance expense for each accounting period. The depreciation policy for depreciable leased assets should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in IFRS 4 and IFRS 16. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of: the lease term or its useful life.

Lessees should make the following disclosures for finance leases:

- for each class of asset, the net carrying amount at the balance sheet date;
- a reconciliation between the total of minimum lease payments at the balance sheet date, and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
    - not later than one year;
    - later than one year and not later than five years;
    - later than five years;

- contingent rents recognised in income for the period;
- the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and
- a general description of the lessees significant leasing arrangements including, but not limited to, the following:
    - the basis on which contingent rent payments are determined;
    - the existence and terms of renewal or purchase options and escalation clauses; and
    - restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Finance lease – a lease that transfers substantially all the risks and rewards incident to ownership of an asset to the lessee (furthermore, the ownership rights may even not be transferred).
Operating lease – any other lease except finance lease (the lessee gains benefit from operating the asset within a short period of time).

For the purposes of classification each specific lease transaction must be considered individually, while the result of the lease classification should be identical for both the lessor and the lessee.
Some cases are given below where it is necessary to consider a lease as a finance lease (upon the fulfilment of one of the following requirements):

** Ownership of the assets are transferred to the lessee by the end of the lease term.*

** The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised.*

** The lease term is for the major part of the economic life of the asset, even if title is not transferred.*

** At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the lease.*

** The lease assets are of a specialised nature such that only the lessee can use them without major modifications being made.*

(Therefore the land lease is normally classified as an operating lease, unless the title passes to the lessee at the end of the lease term, while the lease payments for the land - as prepayments)

5.3. Finance lease (accounting procedures) by lessees

Basis: Transactions and other events must be recorded and presented according to their substance and the financial reality and not only according to their legal form. According to the legal form of a lease contract the ownership of the leased assets may not be transferred to the lessee, but in the case of a finance lease, however, the substance and the financial reality of the contract is such that lessees gain economic benefits from the use of leased assets for the major part of their useful life in exchange for the obligations to pay for these rights the amount which is about the same as the fair value and the respective financial consideration for the asset. Therefore, in order not to undervalue the economic resources and the scope of liabilities of the enterprise:

> 'Lessee should present finance leases as an asset and as a liability for further lease payments. The total asset and liability amount must equal the fair value of the leased assets (less the inception costs of the lease transaction)'.

At the inception of the lease the value of the lease and the amount of the lease liability must be the same. Later these amounts differ as the carrying value of the lease asset is presented by taking into account the depreciation deductions; the amount of the lease liability decreases with the transfer of the lease payments.

The standard provides the following (paragraph 17): 'Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge to be allocated so as to produce a constant periodic rate of interest on the remaining balance of the liability'. Approximate estimates are allowed for apportionment of the finance charge.

In order to estimate the lease payments the following formula can be used:

$$N = \frac{V}{1 - (1 + n)^{t}}$$

where N – the amount payable on a regular basis during the lease term;
n – interest rate of the lease;
V – the value of the asset under lease;
t – number of terms for the lease buyout in the reporting period.

Therefore, the lease payments for the asset under lease are made up of two parts:

- payment for the direct cost of an asset (settlement of the obligation which is presented under liabilities in the balance sheet);

- finance charge (lease interest) that must be allocated by the periods during the lease so as to produce a constant periodic rate of interest on the remaining balance of the liability.

In the financial statements these payments must be presented by separate accounting entries.

Lessee accrues the interest amounts in the account 'Interest expenditure' and includes them to the profit and loss of the reporting period. Lessor includes the amount of interest received under income for the reporting period.

Lessee must account for depreciation of the asset under lease and use the terms of the useful life adopted for similar assets owned and reported under the same class of assets. If, however, there is no reasonable certainty that the lessee will obtain ownership at the end of the lease – the assets should be depreciated over the shorter of the lease term or the life of the asset. While if there is a reasonable certainty that the ownership passes to the lessee at the end of the lease – the assets should be depreciated over the entire useful life of the asset.

Lessee performs depreciation deductions by using the same depreciation methods which are applied in the depreciation of a similar class of owned assets by recognising all lease payments made for the given accounting year in expenses.

5.4. Financial accounting by lessors

The lessor should record the asset transferred under a lease not as an asset, but as a receivable. Any lease payments received from the lessee should be allocated for the settlement of the liability and the financial income. Besides, the recognition of the current financial income should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding.

The initial direct costs incurred as a result of the lease (commission and legal fees) can be at once attributed to the expenses by the lessor or recognised over the entire lease term.

Short-term leases

- Lessor does not include the assets transferred under lease either in the assets or liabilities. Lease payments are presented in the income statement and evenly distributed over the entire lease term.
- Lessor should not change the terms of accounting for the assets transferred under lease. The lease payments obtained is presented as an income which is evenly distributed over the entire lease term.

Premature purchase

If during the term of financial lease the sale of the lessor’s asset takes place (before the end of the contract term – according to an agreed assessment), any gains from the purchase (if the price is lower than the outstanding liability amount) should not be recognised as income for the period, but rather amortised during the remaining lease term.

Disclosures in the financial statements:

By lessee:

- Description of the terms of all leasing relationships;
- Carrying value of assets received under lease;
- Liabilities due to items of assets under lease must be disclosed separately from other liabilities;
- Options for extension of the lease term or premature buyout of the items under lease.

By lessor:

- amounts of receivables for items transferred under lease;
- basis for allocation of the financial income.

Sale and leaseback transactions

Under the sale and leaseback transactions the asset is sold and transferred back under lease to the seller.

The purpose of this transaction is an effective replenishment of the working capital of the seller. The amounts of the lease payments and the selling price are usually interdependent as these are negotiated under a package and does not always reflect the fair value of the asset.

Accounting for sale and leaseback transactions depends on the type of the lease.

In case of a sale and leaseback transaction that results in a finance lease, the sale has never taken place in fact - any risks and rewards attributable to the asset remain with the former owner. The item must be carried in the balance sheet till the end of the lease term. This transaction is in fact the lessor's offer of financial resources to the lessee with the asset appearing as a collateral.

Therefore, even if the proceeds from sale exceed the carrying amount, it does not necessarily need to be recognised at once in the financial statements of the lessee. Instead, this amount is attributed as deferred (accrued) income and amortised over the lease term.

In this respect (following the principle of substance over form) two alternative methods are allowed in accounting for sale of fixed assets under financial leaseback transactions:

- present as a regular loan (sale proceeds constitute the amount of the loan; the difference between the total lease payments and the sale proceeds – cost of the loan financing);

- present as a sale (with possible gains and losses on disposal) and as a subsequent financial lease. In this situation the proceeds from the transaction are recognised, but are not included in the income statement at once and in full amount. Sale proceeds are included directly under the balance sheet liability item 'Accrued income' (deferred income) and subsequently written off to the profit and loss account while using the asset. In this situation, following the terms of the financial lease, the asset and the lease liability is measured at the 'fair value' secured by the lease contract.

5.5. Practical exercises

Exercise 1

On January 1, 2000, enterprises 'Spring' and 'Style' entered into an agreement on the following: 'Spring' transfers machinery with the fair value of 30,000 pounds under a lease to 'Style'. The term of lease is 5 years, during which the enterprise 'Style' must pay an annual lease payment of 9,000 pounds. Ownership of the machinery will be transferred to the lessee at the end of the lease term (at the end of its useful life). Residual value equals 0, the lease interest rate is 14.25%.

You are required:
Complete the following table for the enterprise 'Style', based on the agreement above:

Year	Principal amount of debt at the beginning of year, pounds	Finance charges, pounds	Annual payments, pounds	Principal amount of debt at the end of year, pounds

Exercise 2

Starting on January 1, 2002, lessee takes an asset under lease on the terms of continuous lease with the initial term of 6 years. Lease payments per quarter are USD 1,200 and are paid in advance. Lessee has the right to continue the lease of the asset after the expiry of the initial lease term. Payment for the repairs and insurance of the asset are the obligation of the lessee. The asset transferred under lease has been acquired for cash (USD 20,000) and its useful life is 8 years.

You are required:
Calculate the offered rate of interest for the lease.

6. Accounting for long-term investments Intangible assets (IAS 38)

6.1. Recognition and definitions of intangible assets

This standard is applied by all enterprises in accounting for intangible assets, except for the following assets:

- those intangible assets that are within the scope of another standard;
- financial assets as defined in IAS 32;
- the rights to and expenditure on the research, development and extraction of the following: minerals, oil, natural gas and similar non-regenerative resources;
- any intangible assets arising from an insurer's contractual rights under insurance contracts with the insurance policy holders.

For example, this standard does not apply to:

- those intangible assets held by an enterprise for sale in the ordinary course of business;
- deferred tax assets;
- lease contracts;
- assets arising from employee benefits;
- goodwill acquired in a business combination;
- financial assets.

An intangible asset is an identifiable non-monetary asset without physical substance, held for use in production or provision of goods and services, for leasing out or for administrative purposes.

An asset is a resource:

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

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Useful life is:

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an entity.

Cost is the amount of cash and cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Residual value is the estimated net amount that an entity would obtain from disposal of the asset at the end of its useful life, after deducting the estimated costs of disposal.

Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An active market is a market in which all the following conditions exist:

- the items traded in the market are homogeneous;
- willing buyers and sellers can normally be found at any time; and
- prices are available to the public.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated amortisation and accumulated impairment losses.

The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination. Intangible assets can be clearly distinguished from goodwill if the assets are separable. An asset is separable if it can be rented, sold, exchanged or if the specific future economic benefits attributable to this asset can be divided without disposing at the same time of those future economic benefits arising from other assets used in the same revenue generating operation.

If an asset is separable that is not necessarily a precondition for the asset being individually identifiable, as an entity can make this asset identifiable in another way.

An intangible asset shall be recognised if, and only if:

- it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

The cost of an intangible asset comprises its purchase price, including import duties and non-refundable purchase taxes, and any directly attributable cost of preparing the asset for its intended use. Examples of directly attributable costs are legal fees.

Quoted market prices in an active market provide the most reliable estimate of the fair value of an intangible asset. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an intangible asset, its cost shall be the amount that the entity would have paid for the asset, at the acquisition date, in an arm's length transaction between knowledgeable and willing parties, on the basis of the best information available.
Entities that are regularly involved in the purchase and sale of unique intangible assets may have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in a business combination if their objective is to estimate fair value in accordance with the definition of this standard.. These techniques include, where appropriate, the application of multiples reflecting current market transactions to indicators that drive the profitability of the asset or the discounting of estimated future net cash flows from the asset.
If an entity chooses not to recognise the asset initially at fair value, the entity recognises the asset initially at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use.
An intangible asset may be acquired in exchange for a similar asset with a similar intended use in the same industry and of a similar fair value. Intangible assets may be also sold in exchange for a share of capital interest in a similar asset. In both cases, as the profit generating process is not complete, neither gains, nor losses on such transactions are recognised. The cost of the newly acquired asset in this situation is the carrying amount of the asset given up. However, the fair value of asset acquired and may provide an indication of any impairment loss from the asset transferred. In this situation the impairment loss is recognised on the asset transferred and any carrying amounts after impairment losses are transferred to the new asset.

Internally generated goodwill

Internally generated goodwill shall not be recognised as an asset.
Internally generated goodwill is not recognised as an asset, because it is not an individually identifiable resource which is controlled by the enterprise and the cost of which can be reliably measured.
To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

- a research phase; and
- a development phase.

If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research phase

No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase o fan internal project) shall be recognised as an expense when it is incurred.

Examples of research activities are:

- activities aimed at obtaining new knowledge;
- the search for, evaluation and final selection of, applications of research findings or other knowledge;
- the search for alternatives for materials, devices, products, processes, systems or services; and
- the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development phase

An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and use or sell it;
- its ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- its ability to measure reliably the expenditure attributable to the intangible asset during its development.

In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research plan.

Examples of development activities are:
- the design, construction and testing of pre-production or pre-use prototypes and models;
- the design of tools, jigs, moulds and dies involving new technology;
- the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Internally generated brands, newspaper and other publishing titles, customer lists and items similar in substance cannot be recognised as intangible assets.

Cost of internally generated intangible asset
The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria.
The cost of internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by the management. The cost includes the following items, as appropriate:
- cost of materials and services used or consumed in generating the intangible asset;
- salaries, fees and other labour related costs attributable to the personnel directly involved in the generation of the intangible asset;
- any costs directly attributable to generation of the asset, for example, fees to register a legal right and amortisation of patents and licences that are used to generate the intangible asset;
- any indirect costs required for the generation of the asset and that can be in substance and consequently attributed to the asset. Assessment of the indirect costs is carried out following the same principles as for the assessment of indirect costs attributable to stock.

The following are not components of the cost of an internally generated intangible asset:
- selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;
- identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and
- expenditure on training staff to operate the asset.

Recognition of an item of intangible assets requires its compliance to the following criteria:

- *the asset can be identified,*

- *the asset can be controlled,*
- *future economic benefits can be expected.*

The ability to identify the asset is required in order to separate the intangible asset item from the business reputation acquired in a business combination. Intangible assets must be uniquely identifiable as a separate accounting item. *Recognition of a separate intangible asset item in the accounts requires the capability of being separated from the business reputation.*

Control over intangible assets is exercised if the entity has the power to obtain economic benefits from the asset and it is capable of restricting others to access to the respective asset item. The entity controls the use of an asset if its entitlement to the asset is legally protected and can be forcefully executed by legal measures of constraint through the court system (knowledge protected by legal rights – copyright; the obligation of the entity employees to keep confidentiality).

Future economic benefits obtained from an item of intangible assets may include both revenue from the sale of goods and services and economy of future production costs.

Intangible assets are only recognised, if:

- it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

Any costs incurred due to any assets that are intangible by nature can be recognised in the balance sheet as intangible assets only when meeting the criteria of recognition. Otherwise, the costs are written off to expenses the period when incurred.

Criteria for recognition of intangible assets:

- There is a possibility to use them in production, business transactions and management;
- Economic benefits can be obtained from their use over more than one reporting period;
- Not intended and not provided for sale;
- Documents exist evidencing the entitlement of the entity to the use of the asset;
- Capable of being separated from other property as independent accounting items;
- They don't have any material substance or do not have a decisive role in the assessment of property.

The omission of at least one of the criteria prohibits from capitalisation of expenses under the item 'intangible assets'. Intangible assets intended for sale in the normal course of business are recognised as inventories.

Intangible resources that come to the disposal of the entity are classified into those acquired externally or generated internally. Intangible resources acquired externally are usually recognised as intangible assets and measured at their purchase cost. Intangible assets generated internally by the enterprise are only partially recognised as intangible assets. The largest portion of the costs of intangible resources generated internally by the enterprise is recognised as current expenses in the period when incurred. Not all intangible resources are recognised as intangible assets (see the table below).

Recognised as intangible assets	Recognised as reporting period expenses
Patents and licenses	Scientific research expenditure

Copyright	Expenses of preparing for production
Computer software	Self-created enterprise business reputation
Entitlement to the production samples	Customer, market etc. data bases
Development and experimental costs	Advertising, marketing expenses
Costs for preparation of site for objects of nature	Expenses for training of staff
Trading brands and trademarks acquired externally	Expenses for enterprise restructuring or relocation
Measurement of business reputation acquired at takeover of enterprise or their units	Trading brands and trademarks developed by the enterprise
Entitlement to motion pictures or creation and distribution of other video and audio works	

In order to recognise an item of intangible assets generated internally it is subdivided into the research and development phase (stage). Intangible resources arising from the research phase are not recognised as intangible assets. Any research costs are recognised as expenses for the reporting period when incurred. An approximate comparison of the research and development stages is given below.

Research stage	Development stage
• An activity aimed at the acquisition of new knowledge; • Search for the research results and for other types of application of the knowledge, their assessment and selection • Search for alternative raw materials, devices, processes, products, systems and services • Consultation, assessment and final selection of possible alternatives for new or advanced raw materials, processes, etc.	• Designing, construction and performance evaluation of production samples and models, • Designing of tools, templates, forms and matrices for new or upgraded technologies • Designing and operating of and consultations in respect of new experimental equipment which is not suitable for mass production • Designing, construction and performance evaluation of the alternative raw materials, equipment, products etc.

Development costs can be recognised as an asset if the technical feasibility of application of the development results can be demonstrated for the purposes of production and trading or the process of management; there is a plan for use of the development results; reliable information exists about the existence of the relevant market or the possibility to use the results for internal purposes as well as the possibility to reliably measure and assess the amount of expenditure attributable to the intangible asset item.

6.2. Measurement of intangible assets

Intangible assets are initially measured at cost:

- in the case of a single purchase transaction the cost of IA includes the purchase price (including import duties and non-refundable purchase taxes) as well as any expenses directly attributable to bringing the asset to working condition for its intended use;

- in the case of an exchange for other intangible or other types of assets the cost of the item is measured at the fair value of an externally acquired asset equivalent to the fair value of the transferred asset adjusted for any cash expenses for closing the transaction;
- the cost of an asset generated internally by the enterprise equals the amount of expenditure incurred since the intangible asset has first met the criteria of recognition.

Measurement subsequent to acquisition

<u>Benchmark treatment:</u>
Subsequent to initial recognition as an asset, an IA item should be carried at its cost less any accumulated depreciation and losses due to impairment in value.
<u>Allowed alternative approach:</u>
Subsequent to initial recognition as an asset, an IA item should be carried at a re-valued amount, being its fair value at the date of the re-valuation less any subsequent accumulated depreciation and losses due to impairment in value. Re-valuations should be made with sufficient regularity such that the carrying amount does not differ materially from its fair value at the balance sheet date.

Re-valuation

- By re-valuating separate IA items it is required to likewise re-valuate all other items under the class to which the initial asset has been attributed;
- The amount of depreciation accumulated at the re-valuation date is re-assessed in proportion to the amount of change in the carrying value of the fixed asset before depreciation so that after re-valuation the carrying value of the item equals to the re-valued amount;
- If an item of intangible assets is re-valued upwards, the amount of increase must be credited to equity – 'revaluation reserve' (however, only in case if the previous re-valuation losses have not been reported in the income statement);
- If the value of the item of intangible assets decreases as a result of re-valuation, the income for the reporting period must be reduced by the same amount (but only if the gain from previous re-valuations of the same asset have not been presented under the 'revaluation reserve' item;
- In the case of withdrawal of an IA item from operation (sold or otherwise disposed of) the remaining amount on the account 'revaluation reserve' account is transferred to the 'total accumulated retained earnings' account.

6.3. Amortisation of intangible assets

Useful life

- The amortisable amount of intangible assets should be allocated systematically over the entire period of its useful life.
- Computer software and high technology IA may have a short useful life.
- This standard allows for the non-equivocal opinion that the useful life of any IAs does not exceed twenty years.
- In very few cases there will be conclusive evidence that the useful life of any IAs is a definite period of above 20 years. The useful life can be very long, but it is always a definite period of time.

Method of amortisation

The methods of amortisation used do not differ from the fixed asset depreciation methods. The method of accounting for amortisation applied should reflect the pattern of benefits gained by the enterprise. If the pattern cannot be determined reliably, the straight line method of amortisation should be used.

Residual value must be assumed to be 0, except in cases, when either there are third party liabilities to purchase the asset at the end of its useful life or there is an active market in place for the class of such assets.

6.4. Enterprise business reputation

IAS 22 'Business combinations' provides that the difference between the initial amount of the purchase cost of another entity or a substantial stock interest share of that entity, which represents the majority voting in its net assets, and the fair value of the share purchased (exchanged) by the acquirer is the price of the enterprise or the price of the reputation of its operations, which is accounted for as an asset and amortised over its useful life (however, not exceeding 20 years) under the operations of the acquirer.

Examples

Example 1

Entity XX purchased the following assets owned by Enterprise UU:

The purchase price was 40 thousand pounds in cash and 60 thousand of ordinary shares at the par value of 1 pound with the price of 2.4 pounds as of the date of acquisition.

The amount of identifiable assets consisted of the following items:

Land and facilities	80,000
Fixed assets	70,000
Inventories	10,500
Debit entries of the settlement:	8,090
Total:	168,590

Example 2

Acquisition of 70% of the ordinary shares in Enterprise AOA.

As of the date of acquisition the following data were presented on the balance sheet of AOA:

Ordinary shares, 1 pound each		80,000
Preference shares, 1 pound each		.20,000
		100,000
Gain from share issue		70,000
Re-valuation reserve		60,000
Other reserves		15,000
Profit and loss account		95,600
Total:	340,600	

The price for the purchase was 375 thousand pounds, but it was also known that the fair value of a single property of land and facilities owned by AOA exceeded the amount presented in the accounting documents by 100 thousand pounds. The Enterprise AOA did not perform accounting for intangible assets.

Example 3

Acquisition of 95 % of Entity ABC shares. As of the date of acquisition separate assets of Entity ABC were valued in the amount of 920,8000 pounds. The carrying value of the net assets of Entity ABC, including intangible assets, constituted 420,980 pounds. The purchase price was 850 thousand pounds.

7. Accounting for investments and interests in joint ventures

7.1. General approach to accounting for investments Classification of investments

7.1.1. Definitions

Investments are assets which bring in economic benefits in the form of interest, dividends, copyright or lease charges as well as in the form of capital gains. In accordance with the standard fixed assets are not attributed to investments, except for the investment property.

Investment property – investments in tangible assets (usually land and buildings) which are not intended for use in enterprise operations or for sale in the normal course of business.

Types of investments

Short-term — Long-term

Short-term - these are investments that are readily realisable.
Long-term – acquired with the purpose of obtaining on a systematic basis over a long period of time income in the form of interest and dividends or capital gains (due to the increase in value of the investment property).

7.1.2. Measurement of short-term investments

The carrying value of short-term investments is measured:

- at their fair value;
- or at the lowest of the two values: cost or market value.

The use of *the market value* of investments must be applied in accordance with the accounting policy for regulation of investment appraisal by assessing their market value. Any changes in the market value of investments as of the date of each reporting period can be recognised as follows:

- as income (gain) or expense (loss) for the reporting period;
- as an increase (decrease) in capital using the account 'Revaluation reserve', while if there are no reserves on the account, it is recognised as a loss for the reporting period.

Example
In March of 20X3 publicly quoted securities in the amount of Ls 12,000 were purchased. Brokerage fees amounted to 180 lats. The enterprise accounting policy provides that, on preparation of the financial statements, investments should be measured at their market value, while the amount of re-valuation difference should be attributed to the capital account.

Preparation of financial statements is planned as of the 1st date of each quarter. By using the information below perform re-measurement of securities as of each reporting date:

Date	Market value, thous. Ls	Change in value	Account	Revaluation reserve (account balance)
1. 1st July	12.7			
1. 1st October	11.9			
1. 1st January	12.5			

The cost of investment includes the market value of the investment at the date of purchase as well as expenses associated with the purchase (brokerage fees, bank commissions, remuneration, duties, etc.). Besides, the following needs to be taken into account:

- if the investment purchased is exchanged for shares issued by the enterprise or other securities, the investment is measured at the market value of securities to be issued instead of their par value;
- if the investment to be purchased is exchanged for other assets (except for cash), the investment is measured at the fair value of the property transferred in exchange.

In case of an investment portfolio decisions need to be taken about how to measure the changes in the value of investment:
- for the portfolio as a whole;
- by types of investment (categories);
- for each item of investment separately.

Usually for the purposes of accounting for re-valuation of an aggregate short-term investment portfolio the account 'Revaluation of short-term investments' is opened. Upon disposal of investments, any amount of difference between the proceeds from disposal and the carrying value is included in the profit and loss account in the period when the disposal took place.

7.1.3. Measurement of long-term investments

The carrying value of long-term investments is usually measured in the amount of their cost, but if, however, their market value falls below the carrying value, the latter is reduced to the real market value of the respective investment item.

The fair value of long-term investments which is assumed as the carrying value is measured in the result of revaluation of the investments.

7.2. Investments in subsidiaries (IAS 27) and in associates (IAS 28)

Subsidiaries are defined as entities controlled by other entity (called the parent entity). Control is a set of liabilities allowing the parent entity to determine the business and financial policy of its subsidiary with the purpose of gaining benefits from its operations. Normally this requires more than a half of the shares with voting rights.

All performance indicators presented in the financial statements of the subsidiary are combined with the data from the parent company in the consolidated group financial statements illustrating the performance of the entire group of entities. Subsidiaries are not included in the group if it has been acquired with the purpose of re-sale in the nearest future or if it is under conditions where its ability to transfer is assets to the parent company is significantly limited in a long period of time. Investments in such entities are presented in accordance with the general provisions for investment accounting.

The methods of accounting for subsidiaries in the financial statements of the parent entity are as follows:

1) At the actual cost;
2) At the market value, consistent with the general investment accounting methods;
3) According to the equity method; also applied in the case with the associates.

Accounting for investment according to the equity method:
Investments received in the accounting according to the actual cost incurred to the investor are adjusted at the end of each reporting period by the amount of change in the investor's share of the net assets of the entity which is the object of investment. The investor re-values the carrying value of the investment according to the amount of its share of net assets of the investment object and correspondingly adjusts the financial results for the reporting period. The investor reduces the carrying value of the re-valued investment by the amount equal to the amount of return made on the investment. See also the definition on pages 187-188 of the text book.

Associated entities included in the group of the investor differ in that the investor is can significantly influence their financial and operating activities regardless of the fact that such entities cannot be classified as subsidiaries or joint venture entities.

28. IAS 28 defines that significant influence can be exercised if the investor independently or through its subsidiaries owns more than 20% of the shares with voting rights in the object of investment. If the share of the investor is below 20% of the shares with voting rights of the investment object, then such entity cannot be presented among the associates.

Both are secured though certain liabilities, including:

- representation of the investor in the board of directors or in any other similar management body, or the investor is given the possibility to participate in the development of the financial and operational policy of the associate;
- large transactions between the investor and the object of investment;
- exchange of the management personnel or important operative information.

The investor can therefore exercise significant influence also in the situation when it owns less than 20% of the shares with voting rights. If however, more than 20% of the shares are owned, they would not necessarily guarantee significant influence in the entity. Such exemptions must be demonstrated and disclosed in the notes.

Example
In 20X3 the stock company ABC invested 850 thousand lats in the acquisition of 30% of the voting shares in X, AS. In its annual report for 2003 X, AS presented an amount of net profit of 200 thous. lats, one half of which were distributed as dividends to the owners of voting shares. Transactions by ABC, AS:

1. Initial investment in X, AS:
   D Long-term financial investments 850,000
   C Cash at bank 850,000

2. Estimated share of profit:
   D Long-term financial investments 60,000 (Balance Sheet)
   C Profits from interest in associates 60,000 (Income Statement)

3. Dividends received from X, AS:
   D Cash at bank 30,000
   C Long-term financial investments 30,000

In the effect of the above given transactions investments in associates will be the presented in the balance sheet of ABC, AS, where:

Investment at initial cost	850,000
Amount of profit added	60,000
Dividends received	(30,000)
Investment	880,000

The total amount of profit in the income statement must be increased by 60,000 lats as the amount of profit from interest in associates.

If the investor records *the investment at initial cost*, the return made by the investor is recognised only at the total amount of dividends and other income from its share of net profit due from the investment object which is received and recognised by the investor after the date of acquisition of the shares. Any other income from the object of investment must be presented as a reduction in the carrying value of the investment. This method is usually used by the investors if the investment is acquired for re-sale in the nearest future.

7.3. Investment property (IAS 40)

Investment property – investments in tangible assets not intended for use in operations of the enterprise or for sale in the ordinary course of business. The following property is attributed to this category: land, buildings or parts of buildings held by the owner or the lessee (under a finance lease contract) and are used to earn rentals or for capital appreciation, while still being not a part of the production process or the sale of goods and services, are not used for administrative purposes and are not intended for sale.

Apart from investment property the standard also defines **the owner-occupied property**. Properties held by the owner or the lessee (under a finance lease contract) and intended for use in production, sale of goods and services, ordinary sale or enterprise management are attributable to this category.

If the owner can use part of the property to earn rentals from a lease or for capital appreciation, and another part – for generating income from operations, sale of goods, work performance or provision of services, then the carrying value of the property is measured separately.

Example An entity owns a hotel, rents out rooms and collects rental payments. This property can be considered to be an item of investment property. The hotel is generally a block of buildings where the occupants are offered to use different services - catering, servicing and entertainment. Their value is so significant that the hotel building must be recognised as an own-occupied property and presented as such on the balance sheet of the entity.

Therefore, the actual intended use of the property is the reason for attributing it either to investment property or own-occupied property.

A property is included under investment property:

- After completion of construction or re-construction;
- After use in production, management or the completion of a trading transaction;
- After transfer to third parties under operating lease.

A property is excluded from investment property:

- Until use in production, management or the commencement of a trading transaction;

- At the commencement of reconstruction which is a part of the preparation of a sales transaction.

Recognition and initial measurement

Investment property should be recognised as an independent item of accounting under the assets of the enterprise when it is reasonably certain is probable that the rental will be earned or that the capital appreciation will take place, and, besides, in the latter case if the value of the capital appreciation can be reliably measured.

Investment property is initially measured at the cost of acquisition or construction, not excluding also the option of construction on business terms.

Subsequent additional expenditure

These are attributable to an increase in the carrying value of the investment property only if they boost their profit generating capacity.

Further measurement models

40. IAS 40 allows to use the following values for investment property measurement:

- Fair value, while any changes should be included in the profit and loss account;
- Initial cost, in which case the investment property is carried in the balance sheet at the remaining value (less accumulated depreciation and impairment losses).

An investment property should be withdrawn from use on disposal or when the investment property is transferred under a finance lease. If a commercial loan is offered or the payment period is extended the difference between the actual consideration received and the carrying value is recorded separately as interest proceeds.

7.4. Interests in joint ventures (IAS 31)

Forms of joint ventures:

- Jointly controlled transactions;
- Jointly controlled assets (property);
- Jointly controlled entities.

In any case **a contract** is required, where the procedure for exercising the control jointly is stipulated. The information requisite in such contracts is as follows:

- Type of activity, its duration, reporting methods;
- Appointment of the board of directors and the procedure of voting;
- Equity interest of the entrepreneurs;
- The pattern of distribution of revenues, costs and other joint performance results among the entrepreneurs.

Example:

Three consulting firms committed to the development and adaptation of a data processing software for an enterprise, training of its personnel and providing the servicing of the software for the following year. Customer must pay the contractors an amount of 15,000 lats, of which:

- 60% after the delivery of the software product;
- 20% after the training of personnel is completed;
- 20% at the end of the first year of operation of the software.

Consultancy firms have agreed on the performance of joint transactions and the following distribution of income: 45%, 35% and 20%.

The first instalment of 9 thous. lats due after the delivery of the software was credited to the account of the first contractor in the amount of 4.05 thous. lats, second – 3.15 thous. lats, and the third – 1.8 thous. lats.

Each contractor presented its costs incurred in the development of the software in its financial statements and recognised its share of the profit gained.

31. IAS 31 provides that each participant to a jointly controlled transactions presents in its financial statements full assets and liabilities incurred in the result of the joint transactions as well as the subsequent revenues and expenses.

Jointly controlled assets are as follows:

- Property used jointly by two or more enterprises for the fulfilment of certain objectives and gaining of additional benefits. Each party to such a contract receives its share of the output produced through the application of the joint property and carries any costs necessary for its operation in conformity with its share of property or output. Sometimes for the purposes of the management arrangements for the joint property entities are established, but it is optional.

Example

Some entities have jointly constructed an office building, they carry out its maintenance jointly and use the building for own purposes. Part of the unoccupied territory is leased out. Each of the participants receives income from the part of the leased property and carry costs for the operation of their part of the building.

Jointly controlled entities are as follows:

- Organisations which are legally separate entities in the form of a company, which operates independently, but are jointly controlled by the participants; Each party to the contract determines either its share of profit or its share of output (other benefits) and may not unilaterally establish the financial or business policy of the jointly controlled entity.

Participants to a jointly controlled entity must disclose their participation in consolidated financial statements. The basic method of presentation is *the proportionate data consolidation appropriate to the share of each participant.*

In the consolidated balance sheet of a participant includes the share of assets and liabilities for which it is jointly responsible or over which it exercises joint control.

In the consolidated income statement the share of revenues, expenses and profit (loss) form a jointly controlled entity is presented.

7.5. Shares and capital interest

People, who wish to invest their assets in a stock company, realise their plans by purchasing the shares of that stock company. Such investments are called **share capital**, while those who acquire the shares are the members or **shareholders**. As a rule, a certain amount of shares with a definite nominal value constitute the share capital of companies. A share is the unit of shareholder’s property.

The nominal value of a share usually differs from its market value, which is the price that the new owner is willing to pay and the former owner – to receive for a share.

There are two main categories of shares: **preferred** and **regular** or **ordinary** shares. Each of these two categories, however, can be further subdivided into different types of shares. We will discuss seven types of share capital that you will come across in this course.

Let us look at the terms used in the recording of share capital:

Authorised, nominal or registered capital – capital (number of shares) that the company is empowered to issue pursuant to the Articles of Association.

Issued or subscribed capital – the really issued amount of capital (the total amount of the nominal value of all shares).

Called-up capital – a part of the issued share capital (part of the total amount of the nominal value of all shares) for which the payment is called up in accordance with an established share issue schedule or decisions of the company management. Often the shareholders are not required to pay the full amount for the shares at once. A company may allow to pay only a part of the amount for the shares at once, while the remainder is called up in steps, in accordance with the share issue provisions.

Paid-up capital – the amount of called-up capital that has been paid (raised). The difference between the called-up capital and the paid capital is the shareholders' debt, i.e., the amount of capital called-up, but not yet paid in. Capital is considered to be paid for not only when the shareholders have paid for the shares in cash or other assets, but also when the internal company sources are used for this purpose. For example, shares may be given to the company sponsors as an appreciation for their services.

Uncalled capital – issued capital for which the payment has not been called-up yet, i.e., the part of the total amount of the nominal value of the shares not yet called up (the difference between the issued and the called-up capital).

Unissued capital – the part of the called-up (nominal) share capital that has not been issued yet.

Reserve capital – the share of uncalled capital, which following a special decision will be called in from the shareholders only if the company faces serious financial difficulties.

Example The company ABC was incorporated with the nominal share capital of 100,000 pounds, which consisted of ordinary shares at the par value of 1 pound. Of this amount, 62,500 shares were issued and sold. 75 pence per share was the called up price for these shares. The shares were paid in on the reporting date of the company – the 31st of December, and for 1,000 shares less than 75 pence per share were received, causing a deficit of 13 pence per share. Present the share capital of the company in the balance sheet of the company as of 31st December by presenting each of the above mentioned categories of shares individually.

Balance Sheet of Company ABC as of 31st December

Share capital:
Nominal:
Issued:
Called up: pence per share
Less: deficit (not paid)

Therefore:

Registered or nominal capital:
Issued (subscribed) capital:
Raised (called-up) capital:
Paid in capital:
Uncalled capital:
Unissued capital:
Amounts due as payment for capital:

8. Accounting treatment for inventories

8.1. Types of inventories

1. All **stock of goods for sale** has two features in common: (a) property rights for these goods are owned by trade companies and (b) they are completely ready for sale to consumers.

2. Inventories in production enterprises are usually classified into three groups:
a. **finished goods** which are completely ready for sale;
b. **work in progress** - stocks that are in various stages of manufacturing, but haven't yet undergone their full production cycle yet;
c. **raw materials** – stocks that will be used in the production process.

Counting inventories

1. Counting of inventories involves (a) carrying out the stock-take of the goods for sale balances and (b) identification of the property rights for goods for any goods found that have not been accounted for.

2. During the stock-take the physical counting, weighing or measurement of the stock of goods balances takes place. In order to avoid errors in the process of stock-taking, it is necessary to comply with the established control procedures.

3. In respect of any goods in transit, **property rights** are established based on the terms and conditions governing the procedure of transfer of the property rights:

a. **If the property rights are transferred at the moment of dispatching**, the buyer becomes the owner of the goods at the moment of transferring them to the disposal of the carrier (the moment of loading on to the board of a ship at the port of shipping off). In this situation **the costs of shipment** are usually covered by the buyer;
b. **If the property rights are transferred as of the moment of delivery**, the seller remains the owner of the goods until the moment of delivery to the buyer. In this situation **the costs of shipment** are usually covered by the seller.

4. According to the contract of consignment the person storing the goods (*consignor*) is not considered to be the owner. The property rights are retained by the sender of the shipment (*consignee*) until they are sold to the buyer. Goods sold on the terms of consignment must be recognised as inventory by the consignee, and not by the consignor.

8.2. Methods of accounting for inventories

One of the two following methods can be applied in accounting for inventories: (1) the continuous inventory accounting method or (2) the periodic inventory accounting method.

8.2.1. Periodic method of accounting for inventory

When **the periodic inventory accounting method** is applied any revenue from sale of goods is recognised at the date of disposal, just as under the continuous inventory accounting method. However, at the date of sale of the goods the cost of goods is not recognised. Instead there is a stock-take performed at the end of the reporting period in order to determine (1) the cost of the remaining balance of goods and (2) the cost of goods sold during the period reported.

Within the framework of periodic accounting for inventories the purchase of goods for resale is recognised in the account 'Purchased goods'. If the purchase is made in cash, the account 'Cash' is credited, while if the goods are purchased on credit the account 'Trade accounts payable' is credited.

If the quality of the goods does not correspond to any acceptable standards the buyer can return the goods and become entitled to a reduction in the purchase price. Return of goods and application of a discount on the purchased goods are recorded by debiting the account 'Trade accounts payable' or 'Cash' and crediting the account 'Return and devaluation of purchased goods'. The account 'Return and devaluation of purchased goods' is a temporary account that must have a net credit balance.

If the payment takes place during the application of a discount, the amount of the discount is recorded by crediting the account 'Discounts received'. So, for example, if the purchase is made on the terms of '2/10, n/30', the buyer receives a discount of 2% on the condition that the full amount of the pro-forma invoice will be paid in 10 days. If the payment of the pro-forma invoice is not made within the period of the discount the business transaction is recorded as usual – by debiting the account 'Trade accounts payable' and crediting the account 'Cash'.

Cost of goods purchased

When determining the cost of goods purchased (a) in order to calculate the **'net purchase'** amount, the items recorded in accounts 'Return and devaluation of purchased goods' and 'Discounts received', and (b) then any costs of transportation, paid upon the purchase, are added to the 'net purchase' amount (see Figure 6.2).

Cost of inventories

The cost of the remaining balances of the goods under **the periodic inventory accounting method** is determined based on the stock-take performance results. A stock-take includes:

a. The physical counting of the remaining units of goods by ranges of goods;
b. Multiplying the value of one unit of goods by the number of remaining items of goods in each range of goods;
c. By adding up each range of goods the total remaining balance of goods is identified.

Cost of goods sold is determined in two steps:

a. In order to arrive at the cost of goods intended for resale the cost of goods purchased is added to the cost of goods at the beginning of period;
b. Cost of goods at the end of period is subtracted from the cost of goods intended for resale.

8.2.2. Continuous method of accounting for inventory

Under **the continuous inventory accounting method** the physical movement of all goods is tracked, in the result of which the cost of each item of goods is attributed directly to the cost of goods sold.

This method is used if the company trades in expensive commodities of a limited range; furthermore each item of goods is identifiable from the moment of purchase till the moment of sale.

The allocation of the value of inventories to the cost of goods sold can be realised based on the following assumptions in regard of **the movement of costs**: (a) writing off at the cost of the inventory items purchased earliest (FIFO), (b) writing off at the cost of the inventory items purchased last (LIFO) or (c) writing off at the weighted average cost of inventories.

8.3. Methods of valuing inventories

FIFO

The FIFO technique is based on the assumption that the items of inventory that were purchased first are sold first.

a. The actual movement of the stock of goods is often accounted for within this method (see Figure 8.4).
b. Under this method inventories at the end of the period are measured at the cost of purchases made last.

LIFO

The LIFO technique is based on the assumption that the items of inventory that were purchased last are sold first.

a. The actual movement of inventories is seldom accounted for within this method.
b. This method assumes that any goods purchased during the reporting period can be offered for sale regardless of the date of their purchase.
c. Under this method inventories at the end of the period are measured at the cost of purchases made first.

Valuation at the weighted average cost

Valuation at the weighted average cost is based on the assumption of the similar nature of the items of goods for resale.

a. Under this method the value of inventories is related to the cost of goods sold, based on **the weighted average value of an item of goods**.
b. The weighted average value of the item is calculated as the total value of goods divided by the number of items (see Figure 8.4).

8.4. Impact of the methods of valuing inventories on financial performance results

In conditions of increasing prices the use of the FIFO technique results in the presentation of the maximum amount of net profit, LIFO – in the minimum amount, while valuing at the weighted average cost – to a medium indicator. In conditions of falling prices, it is vice versa.

Companies apply different cost valuation methods due to the following factors:

a. Effects made on the balance sheet results: the value of stock according to the FIFO technique is more suitable for the current market price level than under the LIFO technique.
b. Effects made on the amount of taxable income: in periods of high inflation LIFO leads to the maximum amount of reduction in income tax.

8.5. Effect of error from inventory valuation

The effects of any possible errors that can occur in valuing inventories on the items of the income statement for the reporting period are shown below.

Error from inventory valuation	**Cost of goods sold**	**Net profit**
The period opening value of inventories is valued too low	Valued too low	Valued too high
The period opening value of inventories is valued too high	Valued too high	Valued too low
The period closing value of inventories is valued too low	Valued too high	Valued too low
The period closing value of inventories is valued too high	Valued too low	Valued too high

The inventory valuation errors at the end of the period make the following effects on the balance sheet items:

Closing stock balance	**Assets**	**Liabilities**	**Shareholders' equity**
Valued too high	Valued too high	-	Valued too high
Valued too low	Valued too low	-	Valued too low

In financial statements:

a. Inventories are usually presented in the balance sheet under current assets, while the cost of goods sold is deducted from revenue in the income statement.
b. It is required do disclose the information on (1) the main items of inventories, (2) the accounting principles used and (3) the inventory valuation techniques applied.

Application of the continuous inventory accounting method

Under **the continuous inventory accounting scheme** the costs related to the purchase and sale of each unit of goods are recorded in detail, moreover, continuous records of information on the balance of each item of goods is provided. Under this scheme the purchase of goods for further sale is recorded in the account 'Stock of goods'. The balance of goods in the account 'Stock of goods' is reduced by any discounts received at purchase, goods returned and de-valued. Any extra costs related to the purchase of goods (for example, carriage costs) increase the balance of the account 'Stock of goods'.

a. Under the FIFO technique the balance of goods that at the moment of sale were purchased first is attributed to the cost of goods sold.
b. By using **the cumulative weighted average pricing method** whenever a new purchase of goods is made a new weighted average price is calculated as the relationship between the total value of goods for sale and the amount of goods remained in inventory.
c. Under the LIFO technique the balance of goods that at the moment of sale were purchased last is attributed to the cost of goods sold.

8.1. ILLUSTRATION

RECONCILIATION OF BUSINESS TRANSACTIONS LEDGER IN CASES OF CONTINUOUS AND PERIODIC INVENTORY ACCOUNTING

Date	**Transaction**	**Continuous method of accounting for stock**	**Periodic method of accounting for stock**
5th July	**Purchase of goods on credit**	Stock of goods 40,000 Trade accounts payable 40,000	Goods purchased 40,000 Trade accounts payable 40,000
6th July	**Return and de-valuation of goods purchased**	Trade accounts payable 2,000 Stock of goods 2,000	Trade accounts payable 2,000 Return and de-valuation of goods purchased 2,000 Paid for transportation of goods 200
8th July	**Transportation of goods costs paid**	Stock of goods 200 Trade accounts payable 200	Trade accounts payable 200
14th July	Invoices paid, taking up discounts	Trade accounts payable 38,000 Cash 37,240 Stock of goods 760	Trade accounts payable 38,000 Cash 37,240 Discounts received 760
16th July	Sale of goods on credit	Accounts receivable 24,000 Sales revenue 24,000 Cost of goods sold 12,000 Stock of goods 12,000	Accounts receivable 24,000 Sales revenue 24,000 Transaction is not recorded
18th July	*Return of goods purchased*	Return and de-valuation of goods purchased 1,000 Accounts receivable 1,000 Stock of goods 500 Cost of goods sold 500	Return and de-valuation of goods purchased 1,000 Accounts receivable 1,000 Transaction is not recorded
	Cash received upon		

25th July	application of discount	Cash 22,770 Discounts offered 230 Accounts receivable 23,000	Cash 22,770 Discounts offered 230 Accounts receivable 23,000

Figure 8.2 DETERMINING THE COST OF GOODS SOLD

DETERMINING THE COST OF **GOODS PURCHASED**

Purchases		$360,000
Less: Return and de-valuation of goods purchased	$7,000	
Discounts received	3,000	
		10,000
Net purchases		350,000
Costs of transportation paid		5,000
Cost of goods purchased		$355,000

DETERMINING THE COST OF **GOODS SOLD**

Inventories as of 1st January	$40,000
Cost of goods purchased	355,000
Cost of goods for sale	395,000
Inventories as of 31st December	50,000
Cost of goods sold	$345,000

Figure 8.3

INCOME STATEMENT INDICATORS OF TRADE COMPANIES USING THE PERIODIC INVENTORY ACCOUNTING METHOD

Net revenue	Sales revenue - Return and de-valuation of goods sold - Offered discounts = Net sales revenue
	- Purchase of goods sold - Discounts received = Net purchases + Goods transportation costs paid = Cost of purchases
Cost of goods sold	Period opening balance of inventories + Cost of purchases = Cost of goods designated for sale - Period closing balance of inventories **Cost of goods sold**
Gross profit	Net sales revenue - Cost of goods sold = Gross profit
Operating expenses	Operating expenses (including transportation costs, paid during the operations) + Administrative expenses = Total operating expenses
Net profit	Gross profit - Total operating expenses = Net profit

Figure 8.4
CALCULATION OF THE COST OF INVENTORIES UNDER THE LIFO, FIFO AND THE WEIGHTED AVERAGE COST TECHNIQUES USING THE PERIODIC INVENTORY ACCOUNTING METHOD

The following information is available for the reporting year:

	Number of units	Cost per unit	Total value
1. 1st January	80	$ 15	$ 1,200
15. Purchase on 15th March	60	16	960
20. Purchase on 20th June	100	17.5	1,750
25. Purchase on 25th October	90	18	1,620
Total goods for sale	330		5,530

It is certain that the quantity of inventories as of 31st December is 110 units.
Calculate the period closing cost of inventories using the inventory valuation techniques familiar to you.

	FIFO	**LIFO**	Weighted average
Cost of goods intended for sale	$ 5,530	$5,530	$ 5,530
LESS: Period closing stock **(FIFO)** Dates: Quantity x Value per unit 25. 25th October (90 x $18) = $1,620 20. 20th June (20 x $17.5) = 350	1,970		
LESS: Period closing stock **(LIFO)** Dates: Quantity x Value per unit 1. 1st January (80 x $ 15) = $1,200 15. 15th March (30 x $16) = 480		1,680	
LESS: Period closing stock **(Weighted average cost)** Total value / Quantity = Cost per unit of product $5,530 / 330 = $16.76 $16.76 x 110			1,844

Presented in the balance sheet

Cost of goods sold	**$ 3,560**	**$ 3,850**	**$ 3,686**

Atspoguļots peļņas un zaudējumu pārskatā

Figure 8.5

DETERMINING THE PERIOD CLOSING VALUE OF INVENTORIES UNDER THE FIFO, LIFO AND WEIGHTED AVERAGE COST TECHNIQUES

A company has announced the following data:

	No of units	Cost per unit	Total
1. 1st January	90	$15	$1,350
15. Purchase on 15th March	60	16	960
20. Purchase on 20th June	100	17.5	1,750
Total goods for sale	250		$4,060

110 units of goods were sold on 25th May, 90 units – on 11th August.

Determine the period closing value of inventories under the FIFO, LIFO and Weighted Average Cost techniques, using the continuous inventory accounting scheme.

FIFO

Date	**Purchases**	**Sales**		**Net balance**	
1st January				(90 x $15)	$ 1,350
15th March	(60 x $16)			(90 x $15) (60 x $16)	$ 2,310
25th May		(90 x $15) (20 x $16)	$1,670	(40 x $16)	$ 640
20th June	(100 x $17.5)			(40 x $16) (100 x $17.5)	$ 2,390
11th August		(40 x $16) (50 x $17.5)	$1,515	(50 x $17.5)	$ 875

LIFO

Date	**Purchases**	**Sales**		**Net balance**	
1st January				(90 x $15)	$ 1,350
15th March	(60 x $16)			(90 x $15) (60 x $16)	$ 2,310
25th May		(60 x $16) (50 x $15)	$1,710	(40 x $15)	$ 600
20th June	(100 x $17.5)			(40 x $15) (100 x $17.5)	$ 2,350
11th August		(90 x $17.5)	$1,575	(40 x $15) (10 x $17.5)	$ 775

WEIGHTED AVERAGE COST

Date	**Purchases**	**Sales**		**Net balance**	
1st January				(90 x $15)	$ 1,350
15th March	(60 x $16)			(150 x $15.4)*	$ 2,310
25th May		(110 x $15.4)	$1,694	(40 x $15.4)	$ 616
20th June	(100 x $17.5)			(140 x $16.9)**	$ 2,366
11th August		(90 x $16.9)	$1,521	(50 x $16.9)	$ 845

* $2,310/150=15.4
**$2,366/140=16.9

8.5. Practical exercises

As of the end of the reporting period (28th February 20X3) a firm valued its inventories at the amount of 41,675 pounds. The following information is available in addition:

- The firm's new supplier recently delivered some items of goods free of charge. These were, however, included in the valuation of inventories in accordance with the pricelist of the supplier at 200 pounds.

- Goods sold to a customer on the terms of consignment were included in the valuation of inventories at the amount shown on the pro-forma invoice of 1,200 pounds. This price included a trade premium of 50%.

- On 27th February 20X3 goods valued at 1,800 were delivered to the warehouse owned by the firm, but these goods were not included in the valuation of inventories as no pro-forma invoice had been received for them as yet.

- It turned out that the goods included in the value of the inventory at cost of 750 pounds are damaged. The goods must be de-valued by 20% to sell them.

- There were some errors discovered in the accounting ledgers. In one of the ledgers the amount entered was increased by 95 pounds than the actual, while in the other - reduced by 160 pounds. There was also an error of transfer discovered - the balance on the warehouse statement has been transferred in the amount of 1,960 pounds, while the correct amount was 1,690 pounds.

<u>You are required to:</u>

a) Adjust the original value of inventories by continuing the completion of the table below.
b) Accompany each adjustment by an explanation and the reference to the relevant accounting principle.

Register of adjustments for valuation of inventories as of 28th February 20X3

Description	Value, pounds	Reference to the accounting principle used
Initial measurement	41,675	
Adjustments 1. Goods acquired free of charge 2. Goods sold on the terms of consignment 3. Goods purchased without a pro-forma invoice 4. Damaged goods 5. Arithmetical errors in accounting ledgers Adjusted value of inventories		

Example 2

At the end of the reporting year on 31st May of 20X3 the accountant of the company 'Viking Motors' was valuing the company inventories and determined their value at 103,210 pounds. Later a set of errors were discovered:

1. Rent payment of 250 pounds had been included in the value of inventories for air heaters leased from the company 'Glow – Warm'.

2. The balance of inventories brought forward in the amount of 1,720 pounds was incorrectly recorded in the value of inventories only as 1,270 pounds.
3. Upon valuation of inventories the goods acquired free of charge had been recorded at the value stated in the pricelist of the supplier of 100 pounds.
4. A damaged package of six engine parts was discovered. This package can be sold at 500 pounds of which the cost of preventing the defects will be 180 pounds. The cost of this package initially was 400 pounds.
5. The goods acquired by 'Viking Motors' on the terms of consignment were recorded by valuing the inventories at their retail prices – in the amount of 750 pounds.
6. Upon valuing the inventories the goods in the amount of 1,2000 pounds were omitted from records, which were delivered to the warehouse of 'Viking Motors' on 28th May 20X3 and at that date the invoice from the supplier had not been received yet.
7. In the course of a stock-take a box of two car lights fell off the shelf breaking apart and was entirely damaged. The purchase cost of these car lights was 150 pounds.
8. On 29th May 20X3 the company receives an invoice from Germany for the amount of 1,500 pounds. Based on the invoice the following postings are made in the general ledger of the company (debit – Purchases, credit – an individual vendor account). However, as the goods had not yet received the warehouse at the moment of the stock-take performance their value had not been included in valuation of inventory.
9. One of the items has been recorded at the retail price of 1,750 pounds. The sales premium for this item is 75%.

<u>You are required to:</u>

a) Adjust the original value of inventories by continuing the completion of the table below.
b) Accompany each adjustment by an explanation and the reference to the relevant accounting principle.

Adjustment register for valuation of inventories as of 31st May 20X3:

Description	Value, pounds	Reference to the accounting principle used
Initial measurement	103,210	
Adjustments		
1. Rented air heaters		
2. Inventory posting error from the previous period		
3. Goods acquired free of charge		
4. Damaged (repairable) goods		
5. Goods acquired on the terms of consignment		
6. Goods acquired not yet invoiced		
7. Damaged goods (non-repairable)		
8. Goods not delivered, already invoiced		
9. Item of inventory valued at the retail price		
10. Adjusted value of inventories		

9. Accounting treatment of financial instruments (IAS 32; IAS 39)

9.1. Financial instruments, financial assets and financial liabilities
9.2. Financial assets
9.3. Recognition of financial assets and financial liabilities (IAS 39)
9.4. Measurement of financial instruments
9.5. Practical exercises

9.1. Financial instruments, financial assets and financial liabilities

A financial instrument is a **contractual relationship** between two legal (physical) entities that gives rise to **a financial asset** of one entity and **a financial liability** or **equity instrument** of another.

A financial asset is cash or a contractual right to claim the payment of cash or delivery of favourable financial instruments from another company, or to exchange financial assets with another entity under conditions that are potentially favourable to the entity that owns the assets.

Financial assets

- Cash assets
- Contractual rights to claim cash and other financial assets
- Contractual rights to exchange financial instruments under favourable conditions
- Equity instruments of another company

Thus, financial assets are usually distinguished from other assets by the following:
- contractual relationship between the participants to the transaction;
- rights to claim cash.

A financial liability is an obligation incurred by a contractual relationship in the meaning of a claim for payment of cash or delivery of other financial assets to another entity.

Financial liabilities

- Contractual obligation to deliver financial assets to another company
- Contractual obligation for unfavourable exchange of financial instruments

Equity instrument – any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Financial liabilities are distinguished from equity instruments by the fact that any interest, dividends, losses and gains from a financial liability is recognised as income or expense in the income statement, while distributions to holders of an equity instrument shall be deducted from the equity account.

Compound financial instruments consist of two component elements:
- a financial liability; and
- an equity instrument.

For example, bonds which are convertible into ordinary shares of the issuing entity. In substance these instruments consist of the following:

- a financial liability to redeem a bond; and
- a call option (equity instrument) giving the holder the right to obtain a fixed number of the entity's ordinary shares at a certain date, which the entity has obligation to issue.

Two types of contractual liability exist under the same instrument. The standard requires a separate recognition of any amounts attributable to a financial liability and an equity instrument in the balance sheet, regardless of the fact that they were incurred and exist as a single financial instrument.

The entity issuing compound financial instruments must present the components of this instrument separately:

- Total sum = amount of the liability component + amount of the equity component
- Quantitative measurement of the equity component + quantitative measurement of the liability component = Total value.

Derivative financial instruments are defined by the three following characteristics:

- the value of such financial instruments changes in response to the change in a specified interest rate, financial instrument price, foreign exchange rate and commodity price as well as in index of prices or rates, credit index, credit rating or other variable;
- it requires an initial net investment that is smaller than would be required for other types of financial instruments;
- it is settled at a future date.

Typical examples of derivatives are: futures and forward, swap and option contracts etc.

Spot rate – foreign exchange market price at which a currency will be delivered on the spot date on the condition that the banks, parties to the transaction will exchange these currencies on the next business day following the transaction date. Spot rate illustrates how much a national currency is worth abroad at the moment of transaction.

Options – financial instruments under which a transaction may or may not be performed on agreed terms and conditions within an agreed period of time (a buy – sell option is offered).

Forward transactions – transactions with goods, securities, currencies or cargos providing for their delivery at a certain future date at a price agreed at the moment of signing the contract.

Forward exchange contract is an agreement for the performance of foreign currency exchange at a future time and at a specified currency exchange rate. Usually forward exchange contracts are signed for the purpose of hedging or speculation. Any profit or loss from any forward exchange contracts is recognised under income for the period in which the respective currency exchange rate changes took place.

Futures contract - a contractual obligation to perform the delivery or acceptance of certain goods (currencies, financial instruments) at a specified price at an agreed future time. This contract may be transferred to other parties and thus it is purchased and sold as a security.

Swap transaction – purchase and sale of foreign currencies at approximately equal values on the condition that the settlement takes place on different dates. Swap transactions are also the foreign currency purchase and sale transactions on the nearest date together with a return swap within a specified term.

Example 1
Below listed are some of the asset items. You are required to indicate, which of these are financial assets and which are non-financial asset items, by putting down a short explanation of your decision:

Asset item	Financial asset	Non-financial asset	Explanation
Cash on hand, in banks, on payment cards	Yes		
Fixed assets			
Inventories			
Accounts receivable from goods and services to be settled in cash			
Bills of exchange, bonds and other debt securities, except those settled in exchange for tangible assets or services			
Shares held in other companies and other equity instruments			
Advances to suppliers			
Accounts receivable from short-term leases, futures contracts on goods			
Accounts receivable on options, purchases of equity instruments, foreign exchange swaps			
Accounts receivable on loan contracts and finance leases			
Financial guarantees and other contingent rights			
Accounts receivable from taxation			
Accounts receivable from defined non-contractual payments			

Example 2
Below some of the liability items are listed. You are required to classify these items as a financial liability, equity instrument or other liability, by putting down short explanations:

Liability item	Financial liabilities	Equity instruments	Other liabilities	Explanatio n
Trade accounts payable				
Bills of exchange and bonds payable from financial assets				
Accounts payable on advances issued for goods and services				
Accrued revenue and guarantees for goods and services				
Accounts payable to issuers of shares for their company shares transferred to buyers (us)				
Accounts payable for bonds and bills of exchange to be redeemed on a certain				

date				
Tax payable				
Obligations under forward contracts to be paid in non-financial assets				
Guarantee liabilities contingent on some future events				
Ordinary shares, options and share purchase (sale) guarantees				
Statutory payments for preference shares				
Non-statutory payments for preference shares				
Minority interest				

9.2. Financial assets

In accordance with the Standard financial assets are classified into four categories:

- Available-for-sale financial assets;
- Held-to-maturity investments;
- Loans and receivables;
- others that are not included in any of the aforementioned classes.

Financial assets held for trading are acquired for the purpose of making profit in the near term. Derivatives are always classified as available-for-sale financial assets.

Held-to-maturity investments include financial instruments with fixed or otherwise determinable payments and sharply fixed maturity dates.

Loans and receivables are financial assets that were incurred as a result of provision of cash, goods and services to another company, other than those that the entity intends to transfer to other entities in the near term (within a short period of time), i.e., that are held for trading.

Available-for-sale financial assets include all other assets which are not classified under any of the aforementioned categories.

9.3. Recognition of financial assets and financial liabilities

An entity may recognise a financial asset or a financial liability in its balance sheet only when the entity obtains the right or assumes an obligation by way of contractual provisions of a financial instrument.

A forward contract, from which an obligation arises for the purchase or sale of a financial instrument or any other goods on a certain date and at a fixed price, must be recognised in the balance sheet as an asset or a liability *on the respective contract execution date*.

The selection of the date for recognition of financial instruments is as follows:

- Recognition is possible *on the date of closing the transaction* (the day when the entity commits to the purchase of a financial asset);
- Recognition is possible *on the settlement date* (the day when the actual transfer of the financial instrument takes place).

Derecognition of a financial asset takes place when the entity loses control over the respective item of financial assets.

Derecognition of a financial liability takes place after the liability is extinguished (fulfilled) or legally cancelled, or after the expiry of the term of the liability.

9.4. Measurement of financial instruments

Initial recognition is made according to the actual cost of purchase of a financial asset or at the actual amount of compensation received according to the estimate of a financial liability. Any expenditure incurred at the moment of closing the transaction are included in the value of the financial instrument at the moment of initial recognition. The initial measurement value of financial instruments designated for recognition is assumed to be their fair value. The best analogue of the fair value of a financial instrument is its market price adjusted by any transaction costs.

Subsequent measurement of financial assets depends on their classification into each of the four categories. Subsequent measurement may only take place either at:
- the fair value; or
- the amortised cost, depending on the classification of the financial assets.

Subsequent measurement of financial assets

At fair value:

- Available-for-sale financial assets
- Financial assets held for trading
- Derivative financial assets (always considered as available-for-sale)

At amortised cost:

- Loans and receivables which are not held for trading
- Held-to-maturity financial assets
- Any financial assets that are not quoted in an active market

Any effects from re-valuation of financial assets to fair value are attributable to:

Net profit (loss) for the period reported:
- Financial assets held for trading
- Available-for-sale financial assets (under the respective accounting policy)

Equity account:
- Available-for-sale financial assets (under the respective accounting policy)

Any gains (losses) recognised in the equity account are transferred to profit (loss) for the reporting period after sale or derecognition

Subsequent measurement of financial liabilities
After initial recognition an entity must measure all financial liabilities at amortised cost, except for those financial liabilities held for trading and for those liabilities arising from derivative financial instruments.

9.5. Practical exercise

Example 1
Measurement of different types of financial assets and the recognition of financial asset changes

On 29 December 20X3 an entity commits to purchasing a financial asset for Ls 1,000 (including transaction costs) which represents its fair value on the day of commitment (execution of transaction). On 31st December 20X3 (at the end of the financial year) and on 4th January 20X4 (settlement date) the fair value of the asset was Ls 1,002 and Ls 1,003, respectively. The value of the asset presented in the financial statements will depend on the category as well as on the selection of the method of recognition): at the date of closing the transaction or at the date of settlement, which is illustrated by the two following tables.

RECOGNITION AT THE DATE OF SETTLEMENT			
Net balance	Held-to-maturity investments – presented at amortised cost	Assets held for trading – re-valued at fair value, besides the changes are attributed to equity	Assets held for trading and available-for-sale assets re-valued at fair value by attributing any changes to net profit or loss
On 29th December 20X3 Financial asset Liability			
On 31st December 20X3 Accounts receivable Financial asset Liability Equity (fair value adjustment) Retained earnings (after net gains or losses)			
On 4th January 20X4 Accounts receivable Financial asset Liability Equity (fair value adjustment) Retained earnings (after net gains or losses)			

RECOGNITION AT THE DATE OF TRANSACTION EXECUTION			
Net balance	Held-to-maturity investments – presented at amortised cost	Assets held for trading – re-valued at fair value, besides the changes are attributed to equity	Assets held for trading and available-for-sale assets re-valued at fair value by attributing any changes to net profit or loss
On 29th December 20X3 Financial asset Liability			

On 31st December 20X3 Accounts receivable Financial asset Liability Equity (fair value adjustment) Retained earnings (after net gains or losses)			
On 4th January 20X4 Accounts receivable Financial asset Liability Equity (fair value adjustment) Retained earnings (after net gains or losses)			

10. Liabilities and provisions

10.1. Meaning of liabilities and provisions
10.2. Contingent assets and contingent liabilities
10.3. Deferred taxes

10.1. Meaning of liabilities and provisions

Liabilities of an entity can be classified into two groups:

- known precisely;
- estimated.

Any precisely known liabilities allow for their measurement and recognition already at the moment when they are incurred.

Estimated liabilities are distinguished by an unknown amount of the liability at the moment when it is incurred and is measured only using an approximate estimate.

37. IAS 37 defines the following:

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.'

Liabilities are classified as legal and constructive.

Legal obligations derive from contractual provisions, legislative requirements or instructions of competent bodies based on effective legislation.

Constructive obligations derive from the ordinary actions of an entity or from its published policies. Legal obligations can be both precisely known and approximately estimated liabilities. Constructive obligations most often are approximately estimated liabilities.

> *Trade liabilities* are distinguished from provisions by the fact that the timing and amount of future expenditure is precisely measured, as trade payables are recognised only when the goods or services have been supplied or received and the invoice has been issued.
>
> *Accruals* are liabilities to pay for goods or services that have been received or supplied, but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to agreed vacation pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

A provision is a liability of uncertain timing or amount. In this meaning provisions look like rather abstract values. However, provisions are well distinguished and estimated liabilities.

Provisions can be recognised as estimated liabilities on the following conditions:

- the presence of a legal or constructive obligation;
- the outflow of resources embodying economic benefits that will be required to settle the obligations is probable; and
- a sufficiently reliable estimate of the amount of the obligation can be made.

As it is not possible to estimate the amount of provisions precisely, IAS 37 lays down that 'the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The best estimate – it is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period.'

The risks and uncertainties shall be taken into account in reaching the best estimate of a provision. It is outlined in the standard that the presence of uncertainty and risk does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. When there is an obvious effect caused by any changes in the value of money arising from the passage of time, the amount of provision must be estimated based on the discounted amounts of the expenditure

that will be required for the repayment of a liability. The discount rates must reflect the current market assessments of the time value of money and the risks specific to the liability.
A provision must be used only to cover for those risks in respect of which it has been initially recognised.

10.2. Contingent assets and contingent liabilities

Contingent asset

A contingent asset is the result of past events, but such an asset will qualify for recognition criteria only upon the occurrence or non-occurrence of some future events. Moreover, these are uncertain future events. They may occur, and they may not occur. For example, an entity is involved in a lawsuit, in which the probability for the entity to win is estimated as uncertain by the experts. The contingent asset is not recognised in the balance sheet until it becomes virtually certain that the asset meets the asset recognition criteria (but in this situation the asset would no more be a contingent asset).
Contingent assets are not recognised in the balance sheet due to the principle of prudence as its recognition would require the subsequent recognition of the respective revenue that the entity may never be able to gain.
During the period of existence of a contingent asset an entity must assess the surrounding events and circumstances and identify their changes. Until the moment of recognition an entity continues to disclose information on the existence of a contingent asset in the notes to the financial statements.

Contingent liabilities

A contingent liability is the result of past events, while the reality of their existence will be confirmed only on the occurrence or non-occurrence of some future events. The ability of an entity to influence these events is valued as either significantly restricted or non-existent. Contingent liabilities are also all those liabilities the amount of which may not be estimated with a reliable degree of certainty. *An entity must not recognise a contingent liability in its financial statements, but it is responsible for disclosing a contingent liability in the notes*, unless the term of its probable repayment is remote. If the probability that there will be an outflow of economic benefits is reasonably high, an entity must recognise a provision for the obligation and discontinue to consider this obligation as a contingent liability.

Disclosure of information about the provisions in the notes to the financial statements for each class of provisions is shown in the table below.
Review of changes in provisions in the balance sheet

		Increase		Decrease		
Class of provisions	Period opening balance	Additional provisions made	Increase in the discounted amounts	Amounts used	Amounts restored	Period closing balance

Application of the recognition and measurement rules

- Provisions may not be recognised for future operating losses. Expected future operating losses indicate a possible impairment of certain assets (the test of a probable asset impairment should be made).
- Onerous contracts: if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision. The standard defines as

onerous a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

- Restructuring: provisions for restructuring costs is recognised only when the general recognition criteria for provisions are met. Furthermore, a constructive obligation to restructure arises only when an entity has a detailed formal plan for the restructuring. The definition of restructuring includes: sale or termination of a line of business; the closure of a business location or the relocation of business activities; changes in management structure (for example, eliminating a layer of management); fundamental reorganisations

Example 1

A consulting firm ABC provided consulting services to a firm N under a contract for the total amount of Ls 2,500. The amount and value of services provided is certified by a bilaterally signed statement, however, the firm N refused to pay for the services worth of Ls 1,200 without explaining any reasons. The firm ABC, after repeatedly addressing the customer, brought an action to the arbitration court for the amount of Ls 1,320, inclusive of the delay penalties. After the firm N submitted a counterclaim against the firm ABC in the same court for an amount of Ls 1,250 for the performance of services of an insufficient quality of which it as if had notified the consulting firm. According to the lawyer's assessment the probability for the firm ABC to win the case is 50% to 50%.

Required: Demonstrate how and for what amount the aforementioned event may be recognised in the financial statements of the firm ABC. Provide a detailed explanation supporting your decision.

Example 2

The firm ABC sold goods for the total amount of 50 thous. lats with the warranty servicing obligation for a certain period of time. According to the estimates based on past experience the amount of the obligation is 10 per cent of the value of goods sold.

Required: Demonstrate how and for what amount this event may be recognised in the financial statements of the firm ABC. Provide a detailed explanation supporting your decision.

Example 3

Firm N is involved in a lawsuit as a defendant. The amount of the claim against the firm N is 20,000 lats. According to the assessment of the experts there is a high probability at the end of the reporting period that after closing the case the firm N will have to pay the claimant an amount of approximately Ls 10,000.

Required: Demonstrate how and for what amount this event may be recognised in the financial statements of the firm N. Provide a detailed explanation supporting your decision.

10.3. Deferred taxes (IAS 12)

Profit for the reporting period and taxable profit is not one and the same thing. The difference is due to a whole range of reasons:

- the tax legislation provides for possible tax deductions on acquisition of fixed assets;
- the prohibition to make some deductions from the taxable profit considered as expenditure.

<u>Permanent and temporary differences:</u>

Permanent differences are 'permanent' in the sense that in the year following the reporting year they will not be reversed.

In case of any temporary differences, these differences would be reversed in further periods.

The example described below illustrates the concept of deferred taxes.

An entity Kilimanjaro Ltd. commenced its trading on 1st January 20X1. On the same day the entity bought a fixed asset worth 150 thous. lats. Pursuant to the tax legislation no tax is paid in the year of acquisition of the fixed asset. The estimated useful life of the fixed asset is three years. Its scrap value equals zero. The straight line method of depreciation is used in financial accounting of the entity. Profit of the entity excluding accumulated depreciation is 200,000 lats for each year over a period of three years. Corporate income tax rate is 33%.

	20X1	**20X2**	**20X3**	**Total**
Profit excluding depreciation	200,000	200,000	200,000	600,000
Depreciation	50,000	50,000	50,000	150,000
Profit before tax	150,000	150,000	150,000	450,000
Tax: 33% * (200,000 – 150,000)	16,500			
33% * 200,000	-	66,000	66,000	148,500
Profit after tax	133,500	84,000	84,000	301,500

In year 20X1 the amount of taxable profit has decreased from 200,000 to 50,000 lats due to the purchase of the fixed asset. In years 20X2 and 20X3 the taxable profit will be the profit assessed excluding depreciation.

The resulting profit in year 20X1 is considerably higher than in further years (the whole tax deduction amount was used in the first year of the fixed asset acquisition).

Such a situation may be misleading to the shareholders as an impression may be incurred about the unevenness of gaining profit in different periods, although the entity was operating equally well in all three years.

Deferred tax concept is based on the following consideration. In order for the profit to be real it is necessary to equally allocate the benefits from any tax deductions across the three years:

the total tax deduction is 150,000 lats, therefore – 50,000 lats each year, resulting in the annual reduction of the tax amount will be 16,500 lats (33% from 50,000 lats).

Let us assess the average tax amount in each year:

450,000 (profit before tax) * 33% = 148,500 lats

148,500 lats : 3 = 49,500 lats

The process of 'spreading' the profit amounts by deducting the tax amount is presented in the accounts of the entity with the help of deferred taxation. In our example:

Year 20X1

Total amount of taxes 'spread evenly'	49,500
Tax payable	16,500
Additional tax	33,000

This additional tax amount is included in the income statement in the period reported as part of the corporate income tax. It is transferred to the balance sheet account 'Deferred taxation'.

Years 20X2 and 20X3

Total amount of taxation 'spread evenly'	
	49,500
Tax payable	66,000
Reduction in the tax payment	(16,500)

This reduction is deducted in the income statement from the corporate income tax amount. It is transferred from the balance sheet account 'Deferred taxation'.

Let us summarise the results of the situation under consideration:

	20X1		**20X2**		**20X3**		**Total**
	Thous. Ls	Thous. Ls	Thous. Ls	Thous. Ls	Thous. Ls	Thous. Ls	Thous. Ls
Profit before tax		150		150		150	450
Tax: Income tax	16,5		66,0		66,0		
Transfer to/from deferred tax accounts	33,0		(16,5)		(16,5)		
		49,5		49,5		49,5	148,5
Profit after tax		100,5		100,5		100,5	301,5
Net period end balance on the account 'deferred taxes'		33		16,5		0	

Deferred tax liability – any corporate income tax amounts payable in future reporting periods arising due to taxable temporary differences. Generally it is recognised by reducing the net profit for the reporting period or by reducing the amount of capital directly and presenting it as a balance in the statement of the account 'Deferred tax liability'.

Transactions:
A) recognition of a deferred tax liability on the account of net profit:

D Account 'Corporate income tax expenditure'
C Account 'Current liabilities for payments to the state budget'
C Account 'Deferred tax liabilities'

B) decrease in the ***taxable*** temporary differences:

D Account 'Corporate income tax expenditure'
D Account 'Deferred tax liabilities'
C Account 'Current liabilities for transfers to the state budget'

Deferred tax asset – any corporate income tax amounts to be offset in the future reporting periods and arising due to the existence of deductible temporary differences or as a result of any other circumstances. These are generally recognised by deducting from the corporate income tax amount in the income statement or by adding to the amount of equity and presenting under the balance in the statement of the account 'Accounts receivable from deferred tax assets'.
.
A) recognition of deferred tax assets:

D Account 'Deferred tax assets'
C Account 'Corporate income tax expenditure'
C Account 'Shareholders' equity'

B) reduction in the amount of ***deductible*** temporary differences:
D Account 'Current liabilities for payments to the state budget'
C Account 'Deferred tax assets'

Temporary differences between the carrying value of an asset or a liability and their tax bases The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount. If the carrying amount of the asset does not affect the taxation of economic benefits, the tax base is equal to nil. If after the use of a long-term asset the accumulated depreciation for a certain period of time reaches 30%, its tax base will equal 70%, i.e., it will equal the non-depreciated value.

Tax base of a liability equals its carrying value less any amount that will not be taxed in the future periods. For example, advance payments received from customers on future sales. The tax base of this advance payment as a liability equals its carrying amount less the cost of the goods intended for sale.

Current and deferred tax assets and liabilities must be presented separately in the balance sheet.

11. Revenue

11.1. Accounting recognition on an accruals basis

The basic assumption laid down in the IAS is the recognition on an accruals basis including the compliance with the following provisions:

Assumption of periodicity

1. Under **the assumption of periodicity** business activities of an entity can be divided into certain time periods. Reporting periods as a rule are one month, quarter or year. Reporting periods with the duration of one year are called **a financial year**.

Principle of revenue recognition

2. The main issue arising in the accounting for revenues refers to the moment of recognition.
3. **The principle of revenue recognition** means that revenue is recognised in the same reporting period when earned.

Matching principle (see 11.1. Figure 11.1)

4. In accordance with **the matching principle** the resources consumed (expenditure) should be matched against the results achieved by those resources (revenues).

Adjusting entries (see Figures 11.4 and 11.5)

5. Adjusting entries are made to ensure the following:
   a. recognition of revenue in the period when they were earned, and recognition of expenditure in the period when incurred;
   b. the compliance with the principle of revenue recognition and the matching principle.

6. It is necessary to make adjusting entries every time when financial statements are prepared. Adjusting entries may be classified as (a) **prepayments** (deferred income or prepaid expenses recognised on the account of future periods), or as (b) **accruals** (accrued income or expenses).

Prepayments (see 11.2. Figure 11.2)

7. **Prepaid expenses** are expenses which have already been paid and are recognised under assets until the respective economic benefits are realised or consumed.
   a. Prepaid expenses are reduced either after a certain amount of time or as they are realised or consumed.
   b. In the case of prepaid expenses the principle of matching **the asset and expenditure accounts** is applied.
   c. Until adjustment **the assets are overestimated**, while **the expenditure is underestimated**.
   d. Adjustments are made by debiting the expense account and crediting the asset account.

e. An example of prepaid expenses is the expenditure made for insurance, purchase of consumables, prepayment of services.

a. To illustrate the adjusting entry for prepaid expenses, let us consider the following example. Let us assume that on 1st October an entity 'Kubitz' remitted to an insurance company 'Sandy' an amount of USD 2,400 as a payment for an insurance policy covering one year, which takes effect on 1st October, and that is posts the whole amount as prepaid expenses. On 31st October the following adjustment is made:

D Insurance expenses ($2,400 X 1/12)…………. 200
C Prepaid insurance expenses…………………...200

8. **Revenues gained on account of future periods** - revenues already collected, which are recognised under liabilities until they are actually earned.
   a. Deferred revenues are earned after the delivery of goods to buyers or rendering of services to customers.
   b. In the case of deferred revenue the principle of matching **the liability and revenue accounts** is applied.
   c. Until adjustment **the liabilities are overestimated**, while **the revenue is underestimated**.
   d. The adjusting entries are made by debiting the liability account and crediting the revenue account.
   e. An example of deferred income is income from leases, subscription for newspapers as well as the prepayments made by customers by thus paying for future supplies of goods and provision of services.
   a. To illustrate the adjusting entry for deferred income, let us consider the following example. Let us assume that on 1st October the entity 'Schoen' receives a fee of USD 3,000 as a rent payment for the period from October through to December inclusive). On 31st October the following adjusting entry is made in order to reflect the rent earned in October:

D Deferred revenue from rent... 1,000
C Revenue from rent ($3,000 X 1/3).. 1,000

<u>Accruals (see Figure 11.3)</u>

9. **Accrued revenues** - revenues earned but not yet received in terms of money (or in respect of which no invoices are received).
   a. Accrued revenues may arise either after a certain passage of time (for example, in the case of interest or rent payments) or as a result of rendering some services which haven't been billed or collected yet.
   b. Upon accruing for revenue **the matching of asset and revenue accounts** is used.
   c. Until adjustments are made both **assets and revenues are underestimated**.
   d. The adjusting entry is made by debiting the asset account and crediting the revenue account.
   e. To illustrate the adjusting entry for accrued income, let us consider the following example. Let us assume that in October the dentist Mayer rendered the services of a dentist for an amount of USD 800, and that it will be billed only in November. On 31st October the following adjustment is made:

D Accounts receivable.…..…………. 800
C Revenue from rendering of the services of a dentist……… 800

10. **Accrued expenditure** – expenditure incurred but not yet paid (or for which no invoices have been received).

a. Accrued expenditure arises due to the same reasons as accrued revenue. Accrued revenue includes interest, rent and labour fees.
b. In the case of accrued expenses the principle of matching **the liability and expenditure accounts** is applied.
c. Until adjustment **both liabilities and expenses** are underestimated.
d. Adjustments are made by debiting the expense account and crediting the liability account.
e. To illustrate the adjusting entry for accrued expenses, let us consider the following example. Let us assume that the salary payments in an entity 'Schwenk' constituted USD 4,000 for the final week in October, but the disbursement will take place only in November. On 31st October the following adjustment is made:

D Labour consideration expenses.…..………………… 4,000
C Accounts payable for labour fees……..………… 4,000

11. Each adjusting entry affects one balance sheet and one income statement account.

Adjusted statement of turnover

12. After the presentation of all adjusting entries in the journal and the transfer of data from the journal to the general ledger **the adjusted statement of turnover** is prepared. In such a statement of turnover the net balance of all accounts (including the ones that are adjusted) as of the end of the reporting period.

13. **The purpose** of preparing the adjusted statement of turnover is to make sure that after the performance of any adjusting entries the debit amount of all general ledger postings agrees with the credit amount of all postings.

14. Financial statements are prepared on the basis of the adjusted statement of turnover.

Accounting recognition on an accruals basis

15. The principle of revenue recognition and the matching principle is used when performing **financial accounting on an accruals basis**. Under the cash basis of financial accounting any revenue is recognised only after the inflow of cash, while any expenditure – only after they've been paid.

16. Under the IAS it is required to apply accounting on the accruals basis as the application of the cash basis often results in the preparation of financial statements misleading to the users.

Figure 11.1

RECOMMENDATIONS FOR RECOGNITION OF REVENUES AND EXPENSES

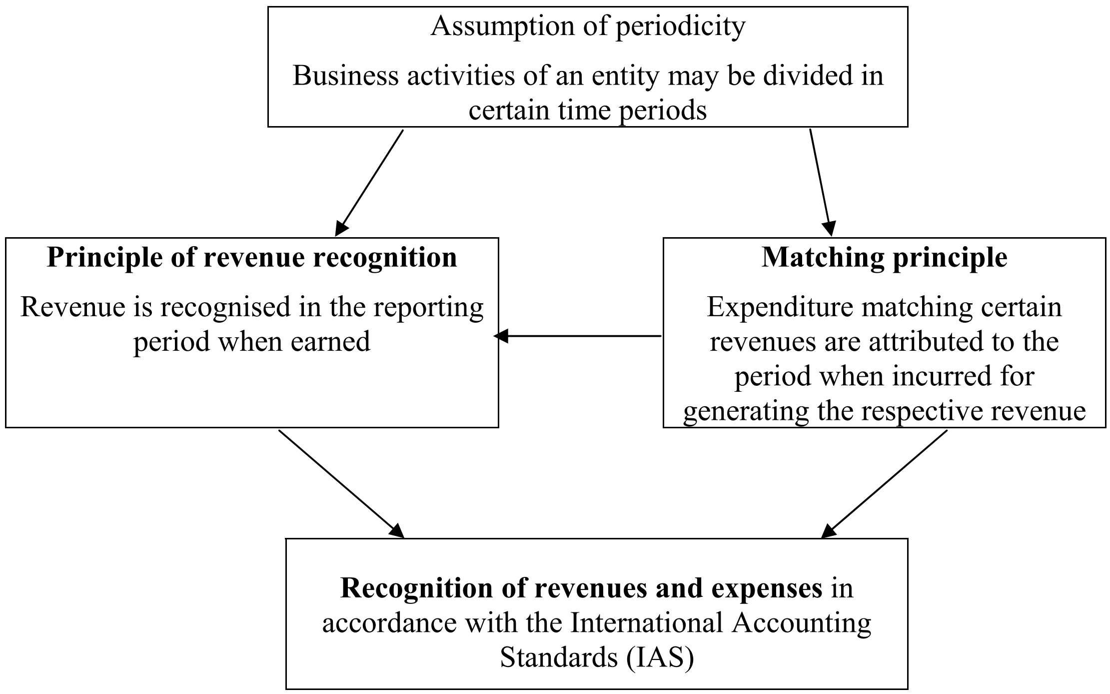
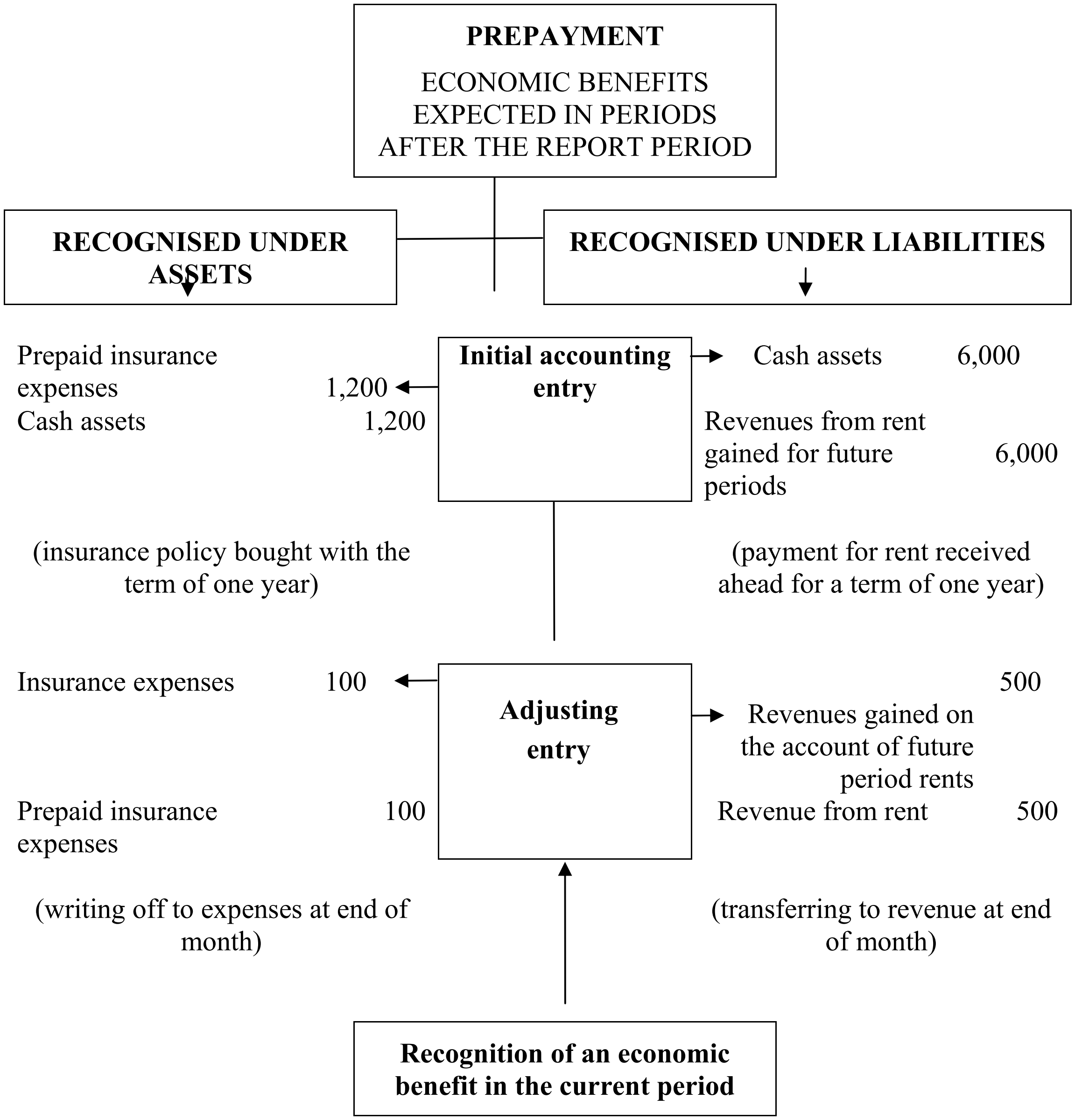


Figure 11.2
PROCEDURE FOR RECOGNITION OF PREPAYMENTS



<u>Financial Accounts Balance Sheet</u>

Prepaid insurance expenses

1,200	100
Net balance 1,100	

Revenues gained on the account of future period rents

500	6,000
	Net balance 5,500

<u>Income statement</u>

Insurance expenses

100	

Revenue from rent

	500

Figure 11.3

PROCEDURE FOR RECOGNITION OF INCOME AND EXPENSE ON AN ACCRUALS BASIS

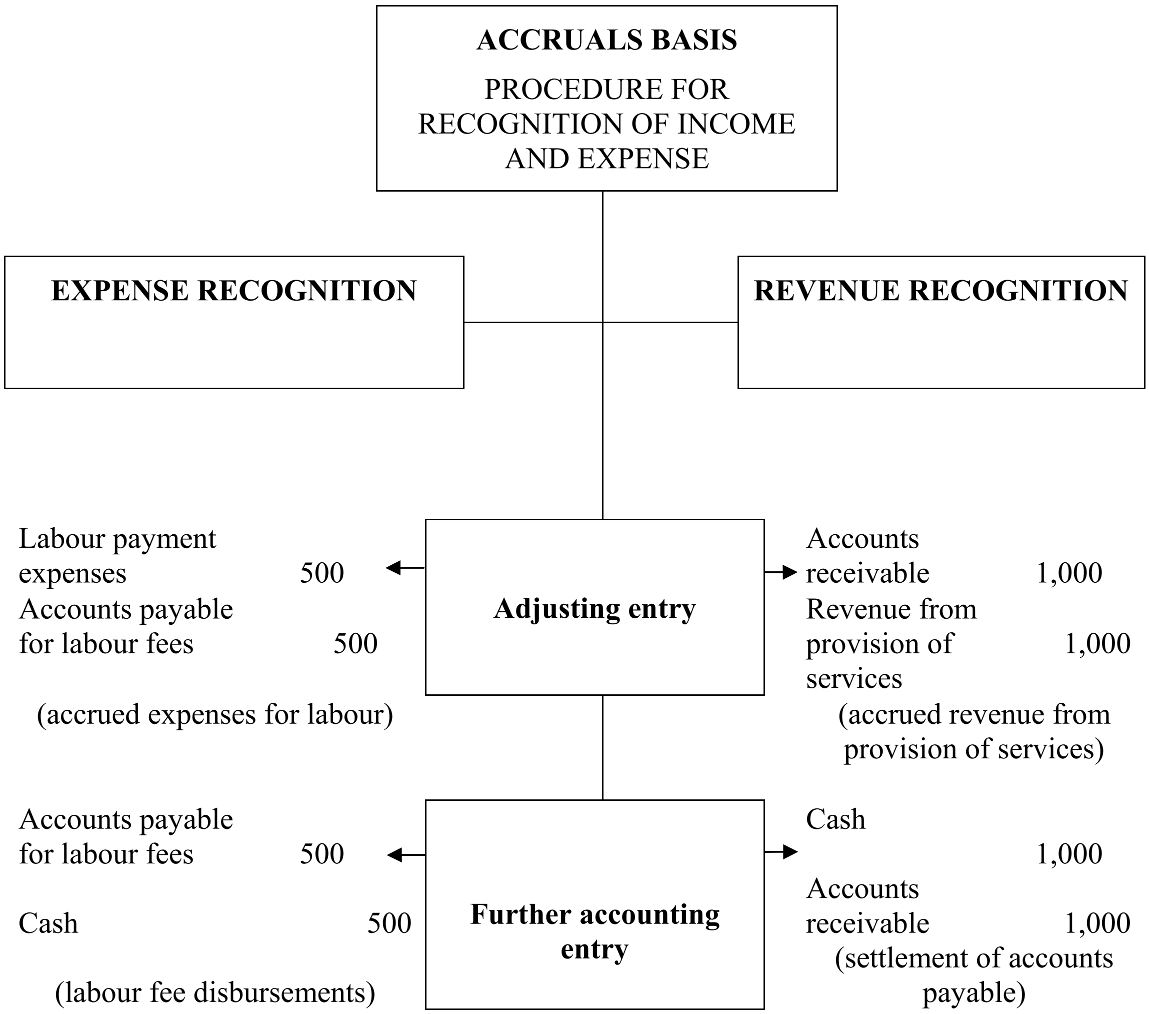


Figure 11.4
TYPES OF ADJUSTING ENTRIES

Types of Adjustment			
	Basis for adjustment	**Net balance of accounts prior to adjustments**	**Adjusting entry**
1. Prepaid expenses	a) recognition of expenditure initially recognised under asset accounts as prepaid expenses	Assets are overestimated Expenses are underestimated	D Expenditure C Assets
2. Revenues gained on account of future periods	b) revenues earned which initially were recognised under liability accounts as revenues gained on account of future periods	Liabilities are overestimated Revenues are underestimated	D Liabilities C Revenue
3. Accrued revenue	c) revenues are earned, while not yet received in monetary terms	Assets are underestimated Revenues are underestimated	D Assets C Revenue
4. Accrued expenses	d) expenditure was incurred, but not yet paid	Liabilities are underestimated Expenses are underestimated	D Expenditure C Liabilities

Each of the adjusting entries affects the financial accounts balance sheet and the income statement

11.2. Concept and measurement of revenue. Bases for revenue recognition (recording – recognition of revenue)

Revenues must be measured at the fair value of the consideration received or receivable. The principal questions that you need to find the answers to are as follows:

- ***when (in which accounting period) the revenues must be recognised?***
- ***what amount of revenue can be recognised?***

Revenues may not be recognised until the moment when they are: a) earned and b) realised. Subsequently the profit also may be recognised only when earned or realised. Recognition of revenue from sale of goods depends on the fulfilment of obligatory conditions. If any of the three conditions is missing no recognition is possible. The following conditions apply:

1) transfer of significant risks and rewards of ownership of the goods from entity to buyer;
2) loss of continuing managerial involvement (to the degree usually associated with ownership) and effective control over the goods sold by the entity;
3) there is a high probability that the economic benefits associated with the transaction will flow to the entity; and
4) the amount of revenue and the costs incurred in respect of the transaction can be measured reliably.

Bases for recognition of revenues:

1) Recognition upon delivery means the recognition of revenue in the period when the goods are supplied or services rendered. Shipment of goods is a generally accepted revenue recognition moment in accounting. Moment of sale (for revenue recognition) is the moment when goods and products are dispatched, services are rendered.

2) Sale on order with a full or partial prepayment – revenues are recognised at the moment of delivery of goods.

3) On consignment contract – revenues are recorded at the moment of selling the goods to the third party. Consignor (supplier) ships the goods to the consignee who tries to sell them. However, until the goods are sold they remain under the ownership of the supplier and can be returned to the supplier. Therefore, the consignee may not recognise any revenue from sale until the actual moment of sale of the goods.

4) Entities possessing exclusive rights (for example, for trademarks, know-how), upon sale must recognise the revenues during the entire term of such transaction instead of only when cash from their use is received (‘*franchising*’).

5) Basis for revenue recognition by stages of completion of a contract is used when any works are performed the completion of which requires several years, i.e., the term of contract (construction, spatial development etc.). The contract stipulates either (1) any agreed amounts that the customer shall pay at different stages of completion of the project (a fixed value contract); or (2) a formula according to which the payments made by the customer will depend on the actual expenditure incurred plus a margin of profit (contract with the reimbursement of expenditure). Performance of the works takes place in every reporting period within the term of the contract. If the profit made as a result of the work performance during the period can be reliably measured, then the revenues are recognised in each of such reporting periods. This basis for revenue recognition is called *recognition by stages of contract completion*. If, however, the amount of profit made during the accounting period cannot be reliably measured, any revenue is recognised after the completion of contract. This *basis of accounting for revenue is called recognition upon completion of contract.*

6) *Rendering of services: brokerage commission fees* in advertising and insurance – revenues are recorded only when the services are rendered, i.e., in those periods when the advertisement was actually published or broadcast.
7) Recognition of *subscription fees for press publications and similar items* is spread evenly over the entire period when such items were supplied.
8) *Admission fees, joining and membership fees* Admission fees are included under revenues after the event has been actually held. Joining and membership fees are included under revenues in the period when it is due.
9) *Specialised software designing fees* is recognised under revenues consistent with the development completion stage.
10) Interest, i.e., the charge for use of cash or cash equivalents must be recognised proportionate to the time basis.
11) *Licensing fees* are recorded and recognised evenly throughout the entire period of use of the licence rights.
12) *Dividends* are recognised as revenues at the moment when the shareholders are entitled to receive them, i.e., upon the decision of the general shareholders' meeting.
13) *Cash basis* – recording of revenue upon receipt of cash.

11.3. Trade discounts

In order to avoid the necessity to print the wholesale and retail trading goods directories and pricelists again and again each time the prices are changed, some producers of goods and wholesale entities estimate the prices at a discount from the price quoted in directory or pricelist. Usually the discounts are offered in the following cases: a) if the payment is received within a certain term or if the payment is guaranteed within a certain term (cash discounts); b) for customers buying goods in large parties (premiums); c) other discounts, for example, for loyal customers (rebates). Trade discount is actually a method of pricing, therefore it is allowed not recognise it in the double entry system.

Companies whose main source of revenue is the sale of goods on credit widely use discounts on early payments. When goods are sold on credit both parties must always have a clear understanding of the amounts and the terms of payment. These terms and conditions are usually described in the pro-forma invoice and constitute a part of the purchase – sale contract. For example, if entries '2/10', 'n/30' can be seen on the face of a pro-forma invoice, this means that the debtor may get a discount of 2% if the invoice is paid within 10 days after the issue. Otherwise, the buyer – debtor may wait for 30 days and then pay the invoice in full.

For example, on 20th September an invoice was issued to a buyer for the amount of Ls 300 on the terms of 2/10, n/60. On the date of sale the following accounting entries are made:

20th September	Invoices issued	300

Sales revenue 300

If buyer takes up trade discount by 30th September inclusive, the following entries are made:

30th September Cash 294

Offered discounts 6

Invoices issued 300

At the end of the reporting period on the debit side of the account 'Offered discounts' an amount of expenditure is accumulated which reduces the amount of sales revenue. When preparing the income statement this amount is excluded from the amount of net sales.

Returns of goods sold

Revenues from sale of goods for the current period are reduced by the amount of goods returned:

Returns of goods sold

Invoices issued or Cash

Preparing an income statement, adjustment of revenue for an amount of goods returned is made:

Sales revenue

Returns of goods sold

11.4. Bad and doubtful debts

Doubtful debts include accounts receivable which are not settled within the usual term and are not fully covered by any legal obligations or guarantees. Doubtful debts are considered as an expenditure for sale of goods on credit while the bad debts - as a loss for the period when the sale was realised. The usual term of payment of accounts receivable is 30 days. International accounting standards recommend the making of provisions as an offset for doubtful debts (writing off of bad debts). Why is this necessary?

By recognising the products as sold upon shipment and submission of invoices an entity calculates its profit for the respective sales amount as well as the relevant taxes. In this situation the tax payments are made only on the account of the entity turnover. Subsequently – it is necessary to create a source of investment.

Two ways of estimating provisions are generally known:

1) Based on the analysis of accounts receivable for the previous years (year) the % rate of doubtful debts from the total amount of accounts receivable is estimated (net turnover interest rate method);
2) Based on analysis carried out for each of the invoices payable the invoices are classified into the following groups: a) the payment term is not yet due; b) overdue by 1 – 30 days; 31 – 60 days; delay for 61 – 90 days; delay for above 90 days. After that the expected interest rate of doubtful debts is set for each group of invoices.

The source for creation of provisions is the enterprise profit.

Example

According to the financial position as of 31st December 20X2 the balance of accounts receivable outstanding (the debit amount of account 'Invoices issued') was Ls 500 thousand. In accordance with the estimates of the firm 2% of the debts will not be recoverable. A provision is made for this amount in the Year 20X3:

Account 'Profit and loss' 10000
Provisions* for doubtful debts 10000

In Year 20X3 the debt in the amount of 5,000 lats is recognised as bad and therefore must be written off by offsetting it against the provision:

Provisions for doubtful debts 5,000
Invoices issued 5000

On 31st December 20X3 a new assessment of accounts receivable is carried out and the respective amount of provisions required for 20X4 is estimated. If necessary, the deficit amount of provisions is additionally recognised in the provisions account.

Many small enterprises write off debts which are recognised as bad using the direct write-off method without making any provisions as follows: by debiting the account 'Losses from bad debts' and crediting the account 'Invoices issued'; and at the same time: by debiting the account 'Profit and loss' and crediting the account 'Losses from bad debts'. In Latvia the rights to write off bad debts are laid down in the law of the LR 'On Corporate Income Tax' (Article 9), which provides the following: when assessing the amount of income taxable by the corporate income tax, this amount may be reduced if the entity observes full compliance with the provisions of this Article of the law.

It is necessary to understand the following:

1. Sale of goods is recognised as completed when *the goods are shipped to the buyer*.
2. Recognition of revenue till the cash is received leads to the creation of *accounts receivable*.
3. The concept of *prudence* requires take account of the probability that any of the debtors will not pay the debts. In other words:
4. The amount of accounts receivable shown on the balance sheet may not be overestimated only because the probability of a real default on the payment of debts had not been provided for.
5. The measurement of accounts payable in the balance sheet is adjusted by *provisions for doubtful debts*.
6. Provisions for doubtful debts are made against *profit*.
7. The amount of provisions in practice is estimated based on the degree of probability of occurrence of a certain event, following past experience and on the evaluation of the usual term for repayment of debts.
8. By establishing the provisions the account 'Trade accounts receivable' remains unchanged as it is probable that the debt will be settled. Thus, provisions only insure against the possibility of occurrence of bad debts.

You are required to give answers to the following questions:

1. Which accounting concepts require the establishment of provisions for doubtful debts?
2. If bad accounts receivable are written off the financial accounts, provisions are no more required for doubtful debts. Is this statement true?

11.5. Practical exercises

Questions

1. In accordance with the assumption of periodicity:
a. A transaction may refer only to one accounting period;
b. No estimates can be made if a transaction refers to more than one accounting period;
c. Accounts of an entity may be adjusted only in the period when the entity discontinues its operations;
d. Business operations of an entity may be divided into certain time periods.

2. Pursuant to the revenue recognition principle revenues are presented:
a. Upon the receipt of cash;
b. When the revenues are earned;
c. At the end of each month;
d. In the period when the corporate income tax is paid.

3. In an enterprise operating in the area of rendering services revenues are considered as earned:
a. At the end of each month;
b. At the end of the year;
c. On the date of rendering the service;
d. On the date of receipt of cash.

4. In accordance with the matching principle it is necessary to ensure the matching between:
a. A customer and an enterprise;
b. Expenditure and revenue;
c. Assets and liabilities;
d. A vendor and an enterprise.

5. The shop 'Jim's Spare Parts' performs accounting in accordance with the principle of revenue recognition. On 31st July full servicing was performed on a car. The customer received the car back on 1st August and paid for the service on 5th August. 'Jim's Spare Parts' received the cheque on 6th August. When is it necessary for the shop to recognise the revenues earned?
a. 31. 31st July;
b. 1. 1st August;
c. 5. 5th August;
d. 6. 6th August.

6. A company spent $10 million for the purchase of an office building. During which period the expenditure must be written off to expenses?
a. In the period when the $10 million were disbursed;
b. In the first year of operation of the building;
c. During the useful life of the building;

d. After revenue worth of $10 million is earned.

7. The matching principle implies that any revenues should be matched with the expenses. In other words, this principle provides for mutual matching of:
a. Assets and liabilities;
b. Efforts made and results achieved;
c. Shareholders' dividends and investments;
d. Cash outflows and inflows.

8. On 30th December a batch of goods was sold in a clothing store for an amount of $1,000. On 5th December an invoice was issued to the customer, and on 10th December the store received a cheque. The clothing store uses the revenue recognition principle. On which date the revenue of $1,000 is considered to be earned?
a. 5. 5th December;
b. 10. 10th December;
c. 30. 30th November;
d. 1. 1st December.

9. On 28th February the workers of a furniture factory worked for overtime to finish an order. The enterprise sent an invoice to the customer at the beginning of March and the payment was received in the middle of March. The labour pay for the overtime must be recognised under expenses:
a. in February;
b. in March;
c. In the period when the workers received their pay;
d. Either in February or in March, depending on when the labour pay was disbursed.

10. Adjustment of accounts must be carried out because:
a. The number of accounts is insufficient for recording of all transactions;
b. Many transactions refer to two or more accounting periods;
c. Errors always occur as business transactions are recorded;
d. The management cannot decide, what data should be recorded in the accounting and reports.

11. Adjusting entries:
a. Not required, because the accounting system operates correctly;
b. Usually required until financial statements are prepared;
c. Made when the management intends to modify the account balance;
d. Are made only in respect of the balance sheet accounts.

12. Adjusting entries are required:
a. As some expenses to be written off to expenses at some point are not recorded in the journal;

b. To ensure the recognition of revenues in the period when they are earned, while the recognition of expenses in the period when incurred;
c. When recognising the expenses in the period when incurred;
d. When recognising the revenues in the period when earned.

13. Which of the following statements is false?
a. Adjusting entries are required to comply with the revenue recognition principle.
b. Adjusting entries are required to comply with the principle of matching.
c. Adjusting entries are required to ensure the compliance of the financial statements with the principles of IAS.
d. Adjusting entries are required to reconcile the accounts of the general ledger with the budget of the entity.

14. The asset accounts can be matched with the expense accounts as a result of:
a. Accounting for liabilities;
b. Accounting for revenues;
c. Adjusting entries from prepaid expenses accounts;
d. Adjusting entries from accrued revenue accounts.

15. A company 'Rid' purchased stationery worth of $4.000 and debited the full amount in the account 'Stationery'. At the end of the reporting period the balance of goods on the stationery account according to the data obtained in a stock-take was $1,200. At the end of the period the following adjusting entry should be made in the journal:
a. debit account 'Stationery expenses' for $1,200; credit account 'Stationery' for $1,200;
b. debit account 'Stationery' for $2,800; credit account 'Stationery expenses' for $2,800;
c. debit account 'Stationery expenses' for $2,800; credit account 'Stationery' for $2,800;
d. debit account 'Stationery' for $1,200; credit account 'Stationery expenses' for $1,200;

16. Accrued revenue is revenue:
a. Which is received and presented under liabilities until earned;
b. Which is earned and presented under liabilities until received;
c. Which is earned, but not yet received;
d. Which is earned, received and presented in accounting.

17. Prepaid expenses are expenses, which are:
a. Paid and presented under asset accounts until recognition;
b. Paid and presented under asset accounts after recognition;
c. Recognised, but not yet paid;
d. Recognised, paid and presented in accounting.

18. Accrued expenses are expenses, which are:
a. Paid and presented under asset accounts until the moment of recognition;
b. Paid and presented under asset accounts after recognition;
c. Recognised, but not yet paid;
d. Recognised, paid and presented in accounting.

19. Deferred revenues are revenues, which are:
a. Received and presented as liabilities until earned;
b. Earned and presented as liabilities until received;
c. Earned, but not yet received;
d. Earned, received and presented in accounting.

20. The liability accounts can be matched with the revenue accounts as a result of:
a. Adjusting entries made to prepaid expenses accounts;
b. Adjusting entries made to accrued expense accounts;
c. Adjusting entries made to deferred revenue accounts;
d. Adjusting entries made to accrued revenue accounts.

21. On 2nd June a laundry firm 'Laundry' purchased detergents worth of USD 6,500 and presented the purchase as an asset. The balance of materials according to the data of a stock-take carried out on 30th June was USD 2,000. On 30th June the adjusting entry to be made is as follows:
a. debit account 'Materials expenses' for $2.000; credit account 'Materials' for $2.000;
b. debit account 'Materials expenses' for $4,500; credit account 'Materials' for $4,000;
c. debit account 'Materials' for $4,500; credit account 'Materials expenses' for $4,500;
d. debit account 'Materials expenses' for $4,500; credit account 'Materials' for $4,500.

22. On 1st July a footwear store 'Footwear' transferred an amount of $9.000 to a real estate company 'ICE' as a rent for 6 months starting on 1st July. The entire amount is recognised as a debit in the account 'Prepaid expenses for rent'. By preparing the financial statements as of 31st July the footwear store 'Footwear' must make the following adjusting entry:
a. debit account 'Rental expenses' for $9,000, credit account 'Prepaid expenses for rent' for $1,500;
b. debit account 'Prepaid expenses for rent' for $1,500; credit account 'Rental expenses' for $1,500;
c. debit account 'Rental expenses' for $1,500, credit account 'Prepaid expenses for rent' for $1,500;
d. ą. debit account 'Rental expenses' for $9,000, credit account 'Prepaid expenses for rent' for $9,000.

23. After the expiry of the term for which prepaid expenses were accounted for the following adjusting entry must be made:

a. debit the asset account and credit the expense account;
b. debit the expense account and credit the asset account;
c. debit and credit the asset account;
d. debit and credit the expense account.

24. On 31st December 20X0 before any adjustments the net balance of the account 'Insurance expenses' of company R was $870 at the year end, while the net balance of the account 'Prepaid expenses for insurance' was $2,300. It was established that prepaid expenses for insurance of $1,800 must be written off. The adjusted net balance of the insurance expenses account will be:

a. $1,800;
b. $870;
c. $2,670;
d. $1,370.

25. Depreciation can be described as the following process:

a. Measurement of assets at fair value;
b. Increase in the value of an asset during its useful life, based on a rational and systematic approach;
c. Write-off of the value of an asset during its useful life, based on a rational and systematic approach;
d. Write-off of the value of an asset to its real value in each accounting period.

26. From the point of view of accounting purchase of a production equipment can be considered as a long-term:

a. Recognition of expenditure;
b. Recognition of revenue;
c. Recognition of deferred revenue;
d. Prepayment for services.

27. Which of the following would not lead to the recognition of deferred revenue?

a. Prepaid expenses for rent;
b. Services provided on credit;
c. Sale of subscriptions for football matches;
d. Sale of subscriptions for magazines for two years.

28. Deferred revenues are classified as:

a. Assets;
b. Revenues;
c. Revenue reduction account;
d. Liabilities.

29. A company 'Gomez' prepared its income statement and balance sheet as of 31st December 20X3, however, there were three adjustment postings missing. In the income statement prepared incorrectly the net profit in the amount of $40,000 was presented. The total amount of all assets included in the balance sheet constituted $120,000, liabilities – $50.000, while the share capital was $70,000.

The following information on the three adjustment postings is available:

1. The provision for depreciation has not been entered in the amount of $9,000.
2. Labour fee for the two final days in December of $6,000 has not been paid and recorded in the accounts. The next disbursement of salaries is planned for January.
3. On 1st December rent was paid for two months ahead of $10,000. The entire amount was debited to the account 'Rental expenses'.

Exercise Mark each of the statements below with the relevant codes:

A. Prepaid expenses
B. Deferred income
C. Accrued revenue
D. Accrued expenses.

<u>STATEMENTS</u>

	1. The revenue is not yet earned, but cash is already received
	2. Raw materials were left over, which will be used in the next period
	3. Received as interest income, but not yet earned.
	4. Rent has not yet been received, but is already earned.
	5. Expenses are recognised, but not yet paid.
	6. Revenues are earned, but not yet received in terms of money.
	7. Expenses are not yet recognised, but have already been incurred.
	8. Interest expenses are recognised, but not yet paid.

12. Construction contracts (IFRS 11). Segment reporting (IFRS 14)

12.1. Description of construction contracts

The procedure of accounting for, presentation in financial statements and disclosure of revenues and expenses associated with the construction contracts is defined in IFRS 11 'Construction Contracts'. This standard is applied for presenting the information in the financial statements of construction and other entities using construction contracts. The possible works under construction contracts include:

- rendering of services directly related to the construction of an asset;
- the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

The standard prescribes the accounting treatment of construction contracts in which the date on which the contract is signed and the date when it is completed do not fall into the same reporting period of an entity. 11. IAS 11 also classifies contracts, distinguishing between the two types of construction contracts:

1) Fixed price contracts (constant price contracts);
2) 'Cost plus contract' (contracts with an incentive fee).

A *fixed price contract* is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A 'cost plus contract' ***is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.***

As the duration of construction contracts may exceed a single accounting period, IFRS

offers two principal methods of accounting for revenue and expenses:

1) the percentage of completion method (by stages of contract completion);
2) the full completion method (after the contract is completed).

Construction contractors may concurrently perform a range of works with different periods of completion, therefore one and the same company in cost recognition under individual contracts may apply both the full completion method and the method using stages of contract completion.

Recognition of revenue by stages of contract completion is applied to contractual works to be performed during several years. Works are performed in each accounting period during the entire contract term, respectively, in the term stipulated in the contract. If the profit made from the contract activities during the period can be reliably measured, then the revenues are recognised in each such reporting period. This period of profit recognition is called recognition *by stages of contract completion*. If, however, the amount earned in the reporting period cannot be reliably measured, the revenue is recognised after the contract is completed. This is *the method of revenue recognition after contract completion*.

12.2. Financial effect of construction contracts

Construction contract revenue must comprise:

- the initial amount of revenue agreed in the contract; and
- variations in contract work, claims and incentive payments as long as they may result in revenue and can be reliably measured.

Construction contract costs must comprise:

- costs that relate directly to the specific contract;
- costs that are attributable to contract activity in general and can be allocated to the contract; and
- such other costs as are specifically chargeable to the customer under the terms of the contract.

When the outcome of a construction contract cannot be estimated reliably:

- revenue must be recognised only to the extent of contract costs incurred that they are recoverable; and
- costs must be recognised as an expense in the period when incurred.

An expected loss must be recognised as an expense immediately.

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs must be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. The stage of completion of a contract can be determined as follows:

- by the proportion that the costs incurred bear the estimated total contract costs;
- by surveys of work performed;
- by completion of a physical proportion (stage) of the contract.

12.3. Disclosure of construction contracts

In financial statements an entity – contractor must disclose the amount of contract revenue recognised as revenue in the reporting period. It is also required to disclose the method used to determine the contract revenue.
For construction contracts in progress, under which the work will be continued also in the next reporting period, an entity must present the aggregate amount of costs incurred and recognised revenues for all contracts open to the reporting date, less recognised losses. Therefore the following reference is included in the IAS: 'An entity shall present:

1) the gross amount due from customers for contract work as an asset; and
2) the gross amount due to customers for contract work as a liability.'

These amounts are calculated based on construction contracts in progress according to the two possible options illustrated below.

	Option A	Option B

Costs incurred under the contract plus recognised profits	20,000	20,000
The sum of recognised losses and progress billings issued under long-term contracts	17,600	21,600
Outcome:		
- payable by customer	2,400	-
- payable to customer	-	1,600

12.4. Segment reporting (IFRS 14)

IAS defines a reporting segment as an individual component of an entity that engages in business activities with the revenues and risks significantly differing from those of other segments. The rules for preparation of segment reporting provide for the following:

- the concept of operating and geographical segment;
- definition of the primary and the secondary reporting formats;
- definition of the segment components.

Concept of operating and geographical segment

The table below gives a summary of the main characteristics of the operating and geographical segments:

Characteristics	Segments	
	Operating	*Geographical*
Concept	The individual component engaged in the production of a product or service or a group of related goods or services and subject to risks and benefits, which differ from the risks and revenues of other operating segments	The individual component engaged in the production of products or services in a specific business environment and subject to risks and benefits, which differ from the risks and revenues characteristic of segments operating in other economic conditions
Main similarities defining the identification of a segment (criterion for aggregation – similarity of the majority of factors)	Products and services are related if the following similarities are found as to: - their nature; - the nature of production processes; - the type or class of customer; - the methods of distribution; - the nature of the regulatory environment for the defined types of activity (for example, banking, insurance etc.)	An area within a country, a country, a group of countries with the following similarities: - similar economic and political conditions; - similarity of operations performed; - specific operation-related risks in the geographical area; - special currency control provisions; - currency risks.

The source of geographical risks can be determined based on the organisational structure of an entity or the internal reporting structure of an entity, therefore the geographical segments of an enterprise can be formed either by the location of its production facilities and operating capacities and other assets, or by the location of its customers and markets.

Risk exposure of the format of segment reporting

An enterprise must select the basic (primary) format depending on the source and nature of risks and revenues. In the table below the possible options of the primary and secondary format are given.

The dominating source and nature of risks and revenues	Segment reporting formats	
	Primary	*Secondary*
Differentiation of goods and services produced	Operating segments	Geographical segments
Differentiation of operations by geographical area	Geographical segments	Operating segments
Both differentiation of goods and services produced and differentiation of operations by geographical area (matrix approach to company management)	Operating segments	Geographical segments
None	Operating, if profit risks and rates are mainly related to the goods produced; Geographical, if profit risks and rates are mainly related to geographical areas	Either geographical or operating, as applicable

An independent reporting segment should be created for each internal reporting operating and geographical segment, if:

- its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all segments;
- the resulting amount is 10 per cent or more of the combined resulting amount of all segments; or
- its assets are 10 per cent or more of the combined assets of all segments.

13. Cash flow statements

13.1. Terms used in cash flow statements
13.2. Basis for preparation of the statement
13.3. Methods for preparation of cash flow statements
13.4. Test and exercises

13.1. Terms used in cash flow statements

Why is it necessary to prepare a cash flow statement?
Statement helps to answer the following questions that may arise to users of financial statements:

1. How was the financing of an entity established (what are the sources of finance)?
2. For what purposes were the funds used?
3. How is the growth in investment financed?
4. How is the repayment of debts arranged? Etc.

The answers for these and for similar questions you may find only in the cash flow statement showing the flow of financing (cash flow) in business activities.

It is assumed to believe that the main cause of business failure is not the shortage of profit, but the shortage of financing for the repayment of debts.

Try to answer the questions below which confirm that the efficiency of performance and the perspectives of an entity do not depend on profit made for a certain period of time alone, but also on the degree of liquidity.

1) Why has the solvency of an entity deteriorated compared to the preceding year in spite of the fact that it operated at a profit?

2) If you were one of the creditors, would you be convinced that a profitable company is operating successfully and that your loans will be repaid?

3) The net profit of a company for the reporting year is 1 million lats. Can the founders hope for obtaining of dividends and the employees - to a rise in their salaries?

So, the amount of profit as a rule does not match the amount of cash acquired. It is largely possible that the entity closed the financial year with high profit, but the balances of the cash accounts are low. The reason is the differences between the principles for preparation of the income statement and the statement of cash flows.

13.2. Basis for preparation of the statement

Let us consider an example illustrating the differences in the bases for preparation of financial statements, by using the information below about the activities of entity N in the current month. You are required to prepare the income statement and to assess the changes in cash balances in the reporting month:

Net sales were 20,000 lats, of which, 3,000 lats on credit;

Purchases in the amount of 25,000 lats, of which, debts to trade suppliers 9,000 lats;

During the reporting month 60% of the purchases of the month were sold;

The amount on the invoice submitted to N by a transport company is 1,000 lats;
Shop rental constitutes 500 lats.

Income statement	*Cash flow statement*
Net turnover	<u>Cash receipts</u>:
Cost of goods sold	Sales
Gross profit	<u>Cash payments</u>:
Sales and distribution costs:	Purchases
rental	Rental
transport	Changes in cash items:
Net profit	

Let us assume that at the beginning of the month the balance sheet of the entity under consideration looked as follows:

Assets		*Liabilities*	
Cash	2000	Capital	2000

At the end of the month, given the above information, the balance sheet would look like this:

Assets	*Liabilities*
Cash	Capital
Accounts receivable	Profit
Goods (inventories)	Owed to:
	- suppliers
	- transport company
Balance:	**Balance:**

The differences between the income statement and the cash flow statement occur due to the different basis of their preparation:

	Income statement	*Cash flow statement*
Basis	Matching basis: revenue and expenses are ‘referred’ to a reporting period.	Cash basis: recording of the fact of cash inflow or outflow, irrespective of the period to which they refer
Components of the statement	Revenues and expenses	Receipts and payments (disbursements)
Object of statement	Overall activities of a company	Operating, investing and financing activities, as well as overall activities of a company
Outcome	Financial performance results: Profit / Loss	Changes in cash items: An increase or a decrease

In the income statement which is prepared on an accruals and matching basis, non-monetary revenue and expense items may be included, such as: revenue from sale on credit, depreciation charge, loss on disposal of fixed assets, cost of goods sold, accrued expenses (accrued salaries, invoices issued and not yet paid), accrued revenues (interest on deposit etc.). Such items are not presented in the statement of cash flows.

13.3. Preparation of cash flow statements

Cash flow statements can be named the 'From Where To Where' statement as it is a summary of the sources and the areas of use of an enterprise financing:

Sources (increase in cash)

Cash gained as a result of operating activities:
- net profit;
- depreciation;

Decrease in any item of assets:
decrease in inventories;
decrease in accounts receivable (except write-off of bad debts);
decrease in total fixed asset amount;

Increase in any item of liabilities:
- outstanding payments;
- obtaining of loans;
- issue of debentures;

Increase in share capital

Areas of use (decrease in cash)

Increase in any item of assets:
increase in inventories;
increase in fixed assets;
increase in accounts receivable;
purchase of securities;

dividend payout;
Decrease in inventories (write-off of bad debts);

Decrease in any item of liabilities:
- payment of accrued expenses;
- repayment of loans;
- redemption of debentures;

Increase in prepaid expenses;
Increase in tax advance payments;

Before you start preparing a statement you need to do the following:

1) Classify the cash flows of a company according to the following areas:
- Operating activities, i.e., the core operations under which the revenue and expenses of an entity are accounted for the assessment of net profit or loss:
- Investing activities which are as follows:
  - (1) acquisition and disposal of investments and long-term assets;
  - (2) issuance of loans and repayment of assets received in loans;
- Financing activities affecting the items under equity and liabilities, including:
  - (1) obtaining cash from issuance of debt instruments and repayment of borrowed assets;
  - (2) obtaining of cash from issue of shares or other equity instruments.

Significant transactions which are not related with the use of cash (such as conversion of bonds into ordinary shares and acquisition of assets in exchange for shares or bonds) must be excluded from the statement of cash flows. Similar transactions must be presented separately either in the closing part of the cash flow statement or in notes to the financial statements.

Typical classification of cash receipts and disbursements by types of activities

Operating activities

Cash receipts

From sale of goods and services

From loan interest and dividends

Cash payments

To suppliers of goods

To employees

Tax expenses

Loan interest

Other expenses

Investing activities

Cash receipts

From disposal of fixed assets and other long-term investments

From sale of securities in other companies

From repayment of loans issued to other entities

Cash payments

For purchase of fixed assets

For purchase of shares in other companies

Issuance of loans to other entities

Financing activities

Cash receipts

From issue of shares

From issuance of own debt instruments (bonds and bills of exchange)

Cash payments

To shareholders in the form of dividends

For redemption of debt instruments and repurchase of own shares

2) **To select the method for preparation of the statement** to be applied to the basic operations of the company:
   - direct; or

- indirect.

By applying these methods, the data from the income statement are converted from *the matching basis* system to *the cash basis* systems.

Let us consider the methods for preparation of cash flow statements on the basis of an example.
Read the financial statements of company N for the year 20X3 (the income statement and the balance sheet). On the basis of these statements, you are required to prepare a cash flow statement.

Four steps can be distinguished in preparing a cash flow statement:
1) Assessment of cash flows from operating activities;
2) Assessment of cash flows from investing activities;
3) Assessment of cash flows from financing activities;
4) Summarising the results of the assessments made during the previous three steps.

Step one:
Cash flows from operating activities can be assessed using the direct or the indirect method.

Direct method
Under the direct method each item of the income statement is transformed.
The basis for assessment (initial point) is the amount of net sales.
Assessment of changes in cash flows from operating activities:

Formula used in calculating the cash receipts from trade customers:

Sales revenue	+ Decrease in accounts receivable or – increase in accounts receivable;

Formula used in calculating the cash payments to trade creditors:

Cost of goods sold	+ Increase in inventories or – Decrease in inventories	+ Decrease in accounts payable or – increase in accounts payable;

Formula used in calculating cash payments for operating expenses:

Operating expenses (less depreciation)	+ Increase in prepaid expenses or – Decrease in prepaid expenses	+ Decrease in accrued expenses payable or – Increase in accrued expenses payable

Formula used in calculating cash payments for corporate income tax:

Income tax	+ Decrease in corporate income tax payable or – Increase in corporate income tax payable

Indirect method

Initial point – net profit (outcome under the income statement); therefore, the transformation of each item of the income statement is not required All information is drawn from the balance sheet; information on other income and losses – from the income statement.

In general any increase in cash from operating activities can be assessed according to the following format:

Net profit / (loss)	x; (x)
Adjustments to items which do not present any movement of cash:	
Depreciation	x
(Profit) / loss on disposal of assets	(x); x
(Increase) / decrease in inventories	(x); x
(Increase) / decrease in accounts receivable	(x); x
Increase / (decrease) in accounts payable	x; (x)
Increase / (decrease) in cash	x; (x).

Steps two and three

Under Step three **net cash from investing and financing activities** are assessed, generally based on the data presented in balance sheet items referring to changes in long-term assets and liabilities as well as based on other information.

Step four

A summary of the results of the calculations and the assessment of total changes in cash is made. The total amount of changes in cash calculated in accordance with the cash flow must agree with the amounts of changes in cash calculated by reconciliation of the period opening and closing balance sheet data.

Recalculation of net profit into cash from operating activities

Matching basis	**Cash basis**
Accrued revenue	Revenue adjusted

according to the cash receipts

less

→ **Net profit** →

→ **Net cash flow from operating activities**

Accrued expenses

– Expenses adjusted according to the payments made

INDIRECT METHOD	or	**DIRECT METHOD**
1. Net profit is adjusted by taking account of those income statement indicators which did not affect the amount of the cash flow. 2. Calculations are made allowing for the transfer from net profit to net cash flow from operating activities.		1. Indicators presented in the income statement on a matching basis are adjusted pursuant to a cash basis. 2. The main types of receipts from and payments for operating activities are presented.

13.4. Test and exercises

1. What is the objective of preparing a cash flow statement?

a. provision of information on investing and financing operations in the period reported
b. confirmation of the fact that revenues exceed expenses if net profit is generated
c. provision of information on all cash receipts and payments in the period reported
d. promotion of relationships with the banks

2. Cash equivalents do not include:

a. short-term bills of exchange
b. government bonds
c. treasury market instruments
d. deposits with the term of up to two years

3. Cash equivalents usually are such securities:

a. with the nominal value of $ 1,000 or above
b. with the redemption period of 3 months or less from the date of purchase
c. with the redemption period of at least 6 months from the date of purchase
d. with the redemption term which is the shortest of these two terms: operating cycle or one year

4. Acquisition of land through issuance of ordinary shares is:

a. an operation which is not related with the use of cash assets and which is recognised either at the end of the cash flow statement or in notes to the financial statements;
b. operation related to the use of cash assets and recognised in the cash flow statement;
c. operation unrelated to the use of cash assets and recognised in the cash flow statement;
d. operation recognised in cash flow statements only using the direct method.

5. In cash flow statements the types of the different activities are usually reflected in the following order:

a. operating, investing and financing activity;
b. operating, financing and investing activity;
c. financing, operating and investing activity;
d. financing, investing and operating activity.

6. Financing activity includes:

a. issuing of loans to other entities;
b. purchase of investments;
c. issuance of debt instruments;
d. purchase of long-term assets.

7. Investing activity includes:

a. repayment of any issued credit resources;
b. cash payments from creditors;
c. cash receipts from issuance of shares;

d. costs of assets borrowed.

8. The most important part of the cash flow statement is cash flows from:
a. operations;
b. investing activities;
c. financing activities;
d. basic operations which are not related with use of cash assets.

9. Interest received and dividends can be classified as cash flow from:
a. financing activities;
b. investing activities;
c. operating activities;
d. both operating and financing activities.

10. Which of the following operations does not affect the movement of cash?
a. writing off bad debts;
b. payment of customer debts;
c. sale of own shares repurchased from the shareholders;
d. exercising of rights for premature redemption of debentures.

11. Which of the following activities is unnecessary in preparing the cash flow statement?
a. assessment of changes in cash assets;
b. assessment of net cash flow from operating activities;
c. assessment of net cash flow from investing and financing activities;
d. assessment of the amount of cash on bank account.

12. Increase in accounts receivable during the reporting period means that:
a. revenues calculated according to the principle of matching revenues with costs are lower than the revenues calculated by using the cash principle;
b. revenues calculated according to the principle of matching revenues with costs are higher than the revenues calculated by using the cash principle;
c. revenues calculated according to the principle of matching revenues with costs are equal to the revenues calculated by using the cash principle;
d. costs calculated according to the principle of matching revenues with costs are higher than the costs calculated by using the cash principle;

13. Which of the following activities influences the amount of cash for the period reported?
a. Recognition of any depreciation costs of fixed assets.
b. Announcement of dividend disbursements.
c. Writing off debts the recovery of which is unrealistic.
d. Repayment of accounts payable.

14. The method of accounting pursuant to which net profit is adjusted by taking into account any operations that do not affect the movement of cash is called:

a. direct method;
b. indirect method;
c. working capital method;
d. method of matching revenues with expenses.

15. When using the indirect method, any increases in prepaid expenses for the period reported:

a. are deducted from net profit;
b. are added to net profit;
c. are neither deducted nor added, because it does not affect the amount of profit;
d. are neither deducted nor added, because it does not affect the amount of costs.

16. When using the indirect method, any expenses for writing off patents for the period reported:
a. are deducted from net profit;
b. result in the increase of the amount of cash;
c. result in the decrease of the amount of cash;
d. are added to net profit.

17. What should be deducted from net profit, when using the indirect method?

a. fixed asset depreciation expenses;
b. increase in accounts receivable;
c. increase in accounts payable;
d. decrease in prepaid expenses.

18. Which of the items listed below do not participate in the adjustment of profits when using the indirect method?
a. Expenses for depreciation of fixed assets.
b. Increase in prepaid expenses for insurance.
c. Increase in the value of a unit of land property.
d. Depreciation expense.

19. When the indirect method is used for the expense of patent write-offs:
a. it is added to the net profit from operating activities;
b. it is deducted from the net profit from operating activities;
c. it is recognised as a cash receipt in the section for investing activities;
d. it is recognised as a cash expense in the section for investing activities.

20. On disposal or equipment for cash the amount received is recognised as:
a. cash receipts from operating activities;
b. cash receipts from financing activities;
c. cash receipts from investing activities;
d. cash expense related with operating activities.

21. Which of the transactions below does not belong to financial activities?
a. Buyout of own shares.
b. Dividend payout.
c. Issuance of discounted bonds.
d. Purchase of long-term debentures.

22. Which item below is not recognised in the cash flow statement using the direct method?
a. Cash payments to suppliers.
b. Cash receipts from customers.
c. Expenses for depreciation of fixed assets.
d. Cash receipts from disposal of equipment.

23. Which items below are not recognised in the operating segment using the direct method?
a. Cash payments from customers.
b. Corporate income tax paid.
c. Profit on disposal of equipment.
d. Cash paid to employees.

24. Below the individual transactions of Elway Company are listed:
1. Ordinary shares were sold at a price above their par value.
2. Debentures have been issued in exchange for cash.
3. Interest has been received on short-term bills of exchange with due redemption term.
4. Goods have been sold for cash.
5. Purchases of the stock of goods and materials have been made in cash.
6. Equipment has been bought which has been paid by a 10% bill of exchange with the redemption period of up to three years.
7. Dividends on ordinary shares have been announced and paid out.
8. 100 shares of Company 'XYZ' have been purchased in cash.
9. Land has been sold in cash according to the book value.
10. Debentures have been converted into ordinary shares.

You are required to state, to which of the following types of activities each of the above mentioned transactions belong.
a) operating transaction;
b) investment transaction;
c) financial transaction or
d) investment and financial transaction without the involvement of cash.

25. For the financial year the company 'PEK' reported a net profit of $300,000. The value of accumulated depreciation on buildings and equipment was $80,000. Period opening and closing balances of short-term assets and short-term liabilities are given below:

	At the end of the	**At the beginning**

	year	**of the year**
Cash	$ 20,000	$ 15,000
Accounts receivable	19,000	30,000
Stock of goods and materials	50,000	65,000
Prepaid expenses	7,500	5,000
Accounts payable	12,000	16,000
Taxation payable	1,600	1,200

Exercise

Using the indirect method, estimate the amount of net cash flow from operating activities.

26. The balance sheet of the corporation 'Looter' is shown below:

Balance Sheet of 'Looter Inc.'

Assets	**Year 20X3**	**Year 20X2**
Cash	$ 41,000	$ 31,000
Accounts receivable	80,000	60,000
Prepaid insurance expenses	22,000	17,000
Land	22,000	40,000
Equipment	70,000	60,000
Provision for depreciation	(20,000)	(13,000)
Total assets	215,000	195,000

Liabilities and shareholders' equity		
Accounts payable	11,000	6,000
Debentures payable	27,000	19,000
Ordinary shares	140,000	115,000
Retained earnings	37,000	55,000
Total liabilities and shareholders' equity	215,000	195,000

Further information:

1. Net loss constituted $15,000.
2. Cash dividends in the amount of $3,000 were announced and disbursed in Year 20X3.
3. Land was sold for cash. Losses constituted $10,000. This transaction has been the only transaction with land performed in Year 20X0.
4. Equipment was sold for $5,000. The original value of equipment was $15,000, accumulated depreciation – $10,000.
5. Debentures in the amount of $12,000 were redeemed during the year.
6. Equipment was bought, for the payment of which ordinary shares were issued. The fair value of the shares at the moment of exchange were $25,000.

Exercise

Prepare the cash flow statement for the year ended 31st December 20X3 by using the indirect method.

27. Below the income statement of the 'Turel' company is presented:

COMPANY 'TUREL'
Income statement
for the year ended 31st December 20X3

Sales revenue		$7,500,000
Cost of goods sold		5,400,000
Gross profit		2,100,000
Operating expenses		
Trading expenses	500,000	
Administrative expenses	700,000	
Expenses for depreciation of fixed assets.	90,000	
Accrued amounts for write-off of intangible assets	30,000	1,320,000
Net profit		780,000

Further information:

1. Accounts receivable increased by $400,000.
2. Inventory of goods and materials was increased by $200,000.
3. Prepaid expenses increased by $200,000.
4. Trade accounts payable increased by $100,000.
5. Accrued expenses payable increased by $180,000.

Exercise

Prepare the cash flow statement with a breakdown by operating activities for the year ended 31st December 20X3 by using the direct method.

28. Below the financial data for the 'Turner' company are given:

COMPANY 'TURNER'

Balance Sheet as of 31st December 20X3

Assets	**Year 20X3**	**Year 20X2**
Cash	$71,000	$35,000
Accounts receivable	85,000	53,000
Stock of goods and materials	**120,000**	**132,000**
Prepaid expenses	19,000	25,000
Investment	90,000	75,000
Fixed assets	315,000	250,000

Provision for depreciation	(65,000)	(60,000)
Total assets	$635,000	$510,000

Liabilities and shareholders' equity

Accounts payable	$93,000	$75,000
Accrued expenses payable	29,000	24,000
Debentures payable	130,000	160,000
Ordinary shares	245,000	170,000
Retained earnings	138,000	81,000
Total liabilities and shareholders' equity	$635,000	$510,000

COMPANY 'TURNER'
Income statement
for the year ended 31st December 20X3

Sales revenue $470,000		
Less:		
Cost of goods sold	$280,000	
Operating expenses (less depreciation expenses)	60,000	
Expenses for depreciation of fixed assets.	17,000	
Income tax	15,000	
Interest expenses	18,000	
Loss on disposal of fixed assets	3,000	
	393,000	
Net profit		77,000

Further information:

1. Fixes assets worth $90,000 were purchased.
2. Fixed assets were sold for $10,000. The initial value of the fixed assets was $25,000, the remaining value – $13,000.
3. Debentures with a par value of $30,000 were converted into ordinary shares worth $30,000.
4. Dividends were announced and paid in the amount of $20,000.
5. Accounts payable are trade accounts payable.

Exercise

Prepare the statement of cash flows for the Year 20X3 by using the direct method.

29. The transactions of the company 'Eldon' were as follows:

1. Accounts receivable were collected.
2. Dividends on ordinary shares have been announced and paid out.
3. Long-term investments sold for cash.
4. Equipment has been acquired in exchange for an issue of ordinary shares.
5. Bills of exchange with the term of five years have been repaid.
6. Salary has been disbursed to the employees.
7. Debentures were converted into ordinary shares.
8. Long-term investments were purchased for cash.
9. Equipment has been sold for cash.
10. Goods were sold for cash.

Exercise
State, to which of the following types of transactions each of the above mentioned transactions belongs:
(a) operating activity;
(b) investing transaction;
(c) financing activity; or
d) investing and financing activity without the use of cash.

14. Accounting treatment of business combinations (IAS 22) Consolidated financial statements and investments in subsidiaries (IAS 27)

14.1. Statements for a group of enterprises

As the enterprise grows and the amount of its transactions increases, the board of directors must establish branches of enterprises or found independent enterprises for a better management of different types of activities. An enterprises can acquire the controlling interest of another enterprise or all of its shares. In practice the decision on a merger of enterprises is adopted in order to increase the value of the enterprises to be merged in the foreseeable future.

Group of enterprises – merger of separate enterprises in a single business entity as a result of incorporation of one enterprise into the other; furthermore, the parent company acquires control over the net assets and operations of another enterprise.

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity. Business combinations (hereinafter – BC) have some generally recognised advantages:

- reduced management expenses;
- improvement of business process coordination (one enterprise is the consumer or supplier of the products of the other enterprise);
- more efficient management of the entire combination assets.

Reasons for establishing a group:

- taxes;
- economic;
- legal;
- financial;
- security interests etc.

Three possible types of business combinations:

- enterprise acquisition;
- enterprise consolidation;
- enterprise merger.

Acquisition takes place when an enterprise (acquirer) acquires control over the net assets and operations of another enterprise (acquiree) in exchange for the transfer of assets, assuming liabilities or share issue. In all cases the owner of the acquired enterprise loses control over the enterprise. In the case of acquisition the number of enterprises (independent legal entities) does not change before and after the establishment of the business combination.

Merger
After mergers only one enterprise remains instead of two. The merged enterprise discontinues its existence as an independent legal entity and is included into the merging enterprise.

Consolidation
In the result of consolidation both ‘consolidated enterprises’ discontinue their existence and another enterprise emerges in their place, which is a combination of enterprises, in fact.

When establishing groups, both horizontal and vertical groups are created.

Peculiarities of statements for a group of enterprises:

- Unlike individual enterprises, groups of enterprises do not legally exist. Parent enterprise and each of the subsidiaries are independent legal entities. If a creditor lends money to a parent enterprise, only the parent enterprise is responsible for the debt.
- Any dividends received from subsidiaries are credited to the profit of the parent enterprise, while their retained earnings are not credited to the profit of the parent enterprise.
- Statements for a group contain consolidated information on the operating results and on the financial position of each enterprise of the group. This means that it is possible to ‘conceal’ the losses made by one subsidiary with the help of another subsidiary; or to ‘conceal’ the insolvency of one subsidiary using the strong financial position of another.
- If a group consists of enterprises operating in various areas of business, the consolidated statements for the group, if the information on each operating segment of the group is missing as requested by IAS 14, can make some significant details unclear.

14.2. Accounting for enterprise acquisition

22. IAS 22 ‘Business combinations’ determine the procedure of accounting for business combination transactions if the combination is achieved by acquisition of enterprises. **Acquisition** takes place when an enterprise (acquirer) acquires control over the net assets and operations of another enterprise (acquiree) in exchange for the transfer of assets, assuming liabilities or share issue.
For recognition of acquisition enterprises use the acquisition method with the following concept:
As of the acquisition date, the acquirer must recognise in the income statement the

operating results of the acquired enterprise; recognise the identifiable assets acquired, the liabilities assumed as well as the positive or negative value of goodwill arising from the acquisition.

Initial measurement and allocation of acquisition is performed based on two alternative methods:

First method: the acquirer must measure (recognise) the identifiable assets acquired and the liabilities assumed at their acquisition date only at the proportionate share of acquirer's interest in the transaction. Any non-controlling interest must be measured at the carrying value of the assets and liabilities of the acquiree before acquisition.
Second method: any identifiable assets and liabilities must be measured at their transaction-date fair value. Non-controlling interest is recognised at the fair value of the non-controlling interest's share of assets and liabilities.

Example Enterprise M acquired 90% of the ordinary shares of enterprise N for 800 thous. lats. On transaction date the assets and liabilities of enterprise N were measured (in lats) as follows:

	Carrying value	*Fair value*
Assets	1,260,000	1,420,000
Liability	610,000	610,000
Net – assets	650,000	810,000

You are required to measure the goodwill arising from the transaction using known methods.

First method (thous. lats):

Acquisition value of enterprise N		800
Fair value of net assets of N	810	
Non-controlling interest in N: 650 * 0.1 = 65		65
Value of net assets of enterprise N acquired by enterprise M (810 - 65 = 745)		745
value of goodwill arising from acquisition of N by enterprise M (800 – 745 = 55)		55

Second method:

Acquisition value of enterprise N		800
Fair value of net assets of N	810	
Non-controlling interest in N: 810 * 0.1 = 81		81
Value of net assets of enterprise N acquired by enterprise M (810 - 81 = 729)		729
value of goodwill arising from acquisition of N by enterprise M (800 – 729 = 71)		71

Therefore by acquisition of 90% of the shares the control over enterprise N is transferred to enterprise M. The owner of enterprise N loses control over the enterprise.

14.3. Principles of consolidation

14.3.1. The main principles for preparing the statements for a group of enterprises

The main principles for preparing the statements for a group of enterprises are as follows:

- the profit amounts of all enterprises in the group must be added together;
- all assets and liabilities of all enterprises in the group must be added together.

Let us consider **an example**. Let us assume that enterprise Radon Ltd. owns 100% of the share capital of enterprise Gray Ltd. Below the financial statements of each enterprise for the current reporting period are given.

	Radon Ltd.	*Gray Ltd.*
	thous. pounds.	*thous. pounds*
Operating profit	55	50
Dividends due from Gray Ltd.	15	-
Profit before tax	70	50
Taxes	20	15
Profit after tax	50	35
Dividends paid	20	15
Retained earnings for the year	30	20

	Radon Ltd.		*Gray Ltd.*	
	£k	*£k*	*£k*	*£k*
Long-term investments				
Tangible assets		100		40
Investment in shares of Gray Ltd.		50		-
Current assets				
Inventories		50		70
Accounts receivable		30		40
Cash		5		15
		85		125
Current liabilities		25		35
Net current assets		60		90
Total assets less liabilities		210		130
Capital and reserves				
Share capital (ordinary shares 1 pound a piece)		100		50
Profit and loss account				
- at the beginning of year		80		60
- retained earnings for the year		30		20
- at the end of year		110		80
		210		130

Rules for preparation of consolidated financial statements:

- Dividends paid by a subsidiary to its parent enterprise may not be recognised twice under profit for the group;
- This means that the only dividends presented in a consolidated income statement are the dividends paid (or due to) the parent enterprise.
- Exceptions to this rule refer to non-controlling interests.
- Any assets constituting investments in subsidiaries are eliminated.
- The respective items in the balance sheet of the subsidiary are eliminated.

Let us prepare the consolidated balance sheet of the Radon group as of ....
Consolidated balance sheet of the Radon group as of ....

	thous. pounds.	thous. pounds
Long-term investments		
Tangible assets		
Current assets		
Inventories		
Accounts receivable		
Cash		
Current liabilities		
Net current assets		
Total assets less liabilities		
Capital and reserves		
Share capital		
Consolidated profit and loss account:		
- at the beginning of year		
- retained earnings for the year		
- at the end of year		

The complications involved in preparation of consolidated financial statements are as follows:
- intragroup items to be eliminated;
- intragroup items to be partially eliminated;
- non-controlling interest;
- intragroup trading activities;
- the value of *goodwill* arising from consolidation;
- profit before acquisition;
- acquisition of shares in subsidiaries via exchange of shares;
- revaluation of shares of subsidiaries.

14.3.2. Intragroup items to be fully eliminated

Intragroup items to be eliminated are the items which are recognised:

a) under assets in one enterprise of the group;
b) under liabilities in the accounts of another enterprise.

Examples:
- Loans issued by one group enterprise to another enterprise of the same group.
- One group enterprise purchases some bonds from another enterprise of the group.
- 'Current account' between two group enterprises involved in trade with each other (purchase of goods from each other). The current account shows what amounts one enterprise owes to the other; the amount, however, owed by enterprise A to enterprise B will be recognised as:
- accounts receivable in the accounts of B;
- as accounts payable in the accounts of A.

14.3.3. Intragroup items to be partially eliminated
If the statements are correctly prepared the assets and liabilities presenting intragroup settlements must be eliminated. For example, if enterprise C owns the bonds of enterprise D for the amount of 50,000 pounds, but the total value of enterprise D bonds is 80,000 pounds, then upon consolidation the following transactions are carried out:

- The asset 'Investments in bonds' of enterprise C worth 50,000 pounds is eliminated;
- The liability of enterprise D 'Bonds issued' worth 80,000 pounds is reduced by an amount of 50,000 pounds to 30,000 pounds, being an amount owed to external creditors and are assumed as liabilities of the group.

Example Prepare the consolidated balance sheet for the Eagle Group

	Eagle Ltd (parent)	*Sparrow Ltd (subsidiary)*
	£k £k	*£k £k*
Long-term investments		
Tangible assets	120	30
Investment in 20,000 shares of Sparrow Ltd.	20	-
Loan issued to Sparrow Ltd.	5	-
	145	30
Current assets		
Current account of Sparrow Ltd.	7	-
Other current assets	48	39
	55	39
Current liabilities		
Current account of Eagle Ltd.	-	7
Other short-term liabilities	30	15
	30	22
Net current assets	25	17
Total assets less liabilities	170	47
Loan from Eagle Ltd.	-	5

Net assets	170	42
Capital and reserves		
Ordinary shares (price – 1 pound a piece)	80	20
Profit and loss account	90	22
	170	42

Enterprise Eagle Ltd. acquired the share capital of Sparrow Ltd. immediately after the registration of the enterprise.

Solution

a) The loan issued by Eagle Ltd. to Sparrow Ltd. is presented in the statements of Eagle Ltd. as an asset, while in the statements of Sparrow Ltd. – as a liability. These two items are excluded as intragroup items to be eliminated.

b) Similarly, the current account between the two enterprises shows that Sparrow Ltd. owes 7,000 pounds to Eagle Ltd. for purchases of goods. Accounts receivable presented in the accounts of Eagle Ltd. eliminate the respective liability in the accounts of Sparrow Ltd.

c) Investment in the subsidiary presented in the statements of Eagle Ltd. (20,000 pounds) eliminates the item 'Share capital' in the statements of Sparrow Ltd.

Consolidated balance sheet of Eagle Group

	£k
Tangible assets (120 + 30)	150
Current assets (48 +39)	87
Short-term liabilities (30 + 15)	45
Net current assets	42
Total net assets	192
Capital and reserves	
Ordinary shares – 1 pound a piece (only shares of Eagle Ltd.)	80
Total profit/loss (90 + 22)	112
	192

14.3.4. Non-controlling interest

Let us assume that the parent enterprise M owns 80% of the shares in a subsidiary D. The shareholders of D own 20% of the shares. The interest of the shareholders is called the non-controlling interest (as it constitutes less than 50% in the equity of D).

Non-controlling interest consists of:

a) the share owned by these shareholders in the share capital of the enterprise (according to the par value of the shares);

b) proportionate share of the reserves (including profit).

If the subsidiary announced the payout of dividends there is a short-term liability presented in the balance sheet which is equal to the amount of dividends due to the non-controlling interest holders. This amount is called 'the announced non-controlling dividends'.

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