CHAPTER 8

Preparation of statements of comprehensive income and financial position

8.1 Introduction

The published accounts of a listed company are intended to provide a report to enable shareholders to assess current year stewardship and management performance and to predict future cash flows. In order to assess stewardship and management performance, there have been mandatory requirements for standardised presentation, using formats prescribed by International Financial Reporting Standards.

The main standard that will be considered in this chapter is IAS 1 *Presentation of Financial Statements*.

Each company sends an annual report and accounts to its shareholders. It is the means by which the directors are accountable for their stewardship of the assets and their handling of the company's affairs for the **past year**. It consists of financial data which may have been audited and narrative comment which may be reviewed by the auditors to check that it does not present a picture that differs from the financial data (i.e. that the narrative is not misleading).

The financial data consist of four financial statements. These are the statement of comprehensive income, the statement of financial position, the statement of changes in equity and the statement of cash flows – supported by appropriate explanatory notes, e.g. showing the make-up of inventories and the movement in non-current assets.

The narrative report from the directors satisfies two needs: (a) to explain what has been achieved in the current year and (b) to assist existing and potential investors to make their own predictions of cash flows of future years.

Objectives

By the end of this chapter, you should be able to:

- understand the structure and content of published financial statements;
- explain the nature of the items within published financial statements;
- prepare the main primary statements that are required in published financial statements;
- comment critically on the information included in published financial statements.

8.2 The prescribed formats – the statement of comprehensive income

The statement of comprehensive income includes all recognised gains and losses in the period including those that were previously recognised in equity.

IAS 1 allows a company to choose between two formats for detailing income and expenses. The two choices allow for the analysis of costs in different ways and the formats[1] are as follows:

- **Format 1**: Vertical with costs analysed according to function e.g. cost of sales, distribution costs and administration expenses; or
- **Format 2**: Vertical with costs analysed according to nature e.g. raw materials, employee benefits expenses, operating expenses and depreciation.

Many companies use Format 1 (unless there is any national requirement to use Format 2) with the costs analysed according to function. If this format is used the information regarding the nature of expenditure (e.g. raw materials, wages and depreciation) must be disclosed in a note to the accounts.

8.2.1 Classification of operating expenses and other income by function

In order to arrive at its operating profit (a measure of profit often recognised by many companies), a company needs to classify all of the operating expenses of the business into one of four categories:

- cost of sales;
- distribution and selling costs;
- administrative expenses;
- other operating income or expense.

We comment briefly on each to explain how a company might classify its trading transactions.

8.2.2 Cost of sales

Expenditure classified under cost of sales will typically include direct costs, overheads, depreciation and amortisation expense and adjustments. The items that might appear under each heading are:

- Direct costs: direct materials purchased; direct labour; other external charges that comprise production costs from external sources, e.g. hire charges and subcontracting costs.
- Overheads: variable production overheads; fixed production overheads.
- Depreciation and amortisation: depreciation of non-current assets used in production and impairment expense.
- Adjustments: capitalisation of own work as a non-current asset. Any amount of the costs listed above that have been incurred in the construction of non-current assets for retention by the company will not appear as an expense in the statement of comprehensive income: it will be capitalised. Any amount capitalised in this way would be treated for accounting purposes as a non-current asset and depreciated.

8.2.3 Distribution costs

These are costs incurred after the production of the finished article and up to and including transfer of the goods to the customer. Expenditure classified under this heading will typically include the following:

- warehousing costs associated with the operation of the premises, e.g. rent, rates, insurance, utilities, depreciation, repairs and maintenance and wage costs, e.g. gross wages and pension contributions of warehouse staff;
- promotion costs, e.g. advertising, trade shows;
- selling costs, e.g. salaries, commissions and pension contributions of sales staff; costs associated with the premises, e.g. rent, rates; cash discounts on sales; travelling and entertainment;
- transport costs, e.g. gross wages and pension contributions of transport staff, vehicle costs, e.g. running costs, maintenance and depreciation.

8.2.4 Administrative expenses

These are the costs of running the business that have not been classified as either cost of sales or distribution costs. Expenditure classified under this heading will typically include:

- administration, e.g. salaries, commissions, and pension contributions of administration staff;
- costs associated with the premises, e.g. rent, rates;
- amounts written off the receivables that appear in the statement of financial position under current assets;
- professional fees.

8.2.5 Other operating income or expense

Under this heading a company discloses material income or expenses derived from ordinary activities of the business that have not been included elsewhere. If the amounts are not material, they would not be separately disclosed but included within the other captions. Items classified under these headings may typically include the following:

- income derived from intangible assets, e.g. royalties, commissions;
- income derived from third-party use of property, plant and equipment that is surplus to the current productive needs of the company;
- income received from employees, e.g. canteen, recreation fees;
- payments for rights to use intangible assets not directly related to operations, e.g. licences.

8.2.6 Finance costs

In order to arrive at the profit for the period interest received or paid and investment income is disclosed under the Finance cost heading.

8.2.7 Preparation of statements of income from a trial balance

The following illustrates the steps for preparing internal and external statements from the trial balance. These are:

- prepare the trial balance;
- identify year end adjustments;
- prepare an internal Income Statement;
- analyse expenses by function into: Cost of sales, Distribution costs, Administrative expenses, Other income and expenses and Finance costs;
- prepare a Statement of comprehensive income for publication.

8.2.8 The trial balance

The trial balance for Illustrious SpA is shown in Figure 8.1.

Figure 8.1 The trial balance for Illustrious SpA as at 31 December 20X1

	€000	€000
Issued share capital		17,250
Retained earnings		57,500
Long-term loan		63,250
Bank overdraft		8,625
Provision for taxation		5,750
Trade payables		29,900
Depreciation – equipment		3,450
– vehicles		9,200
Freehold land	57,500	
Freehold buildings	57,500	
Equipment	14,950	
Motor vehicles	20,700	
Inventory at 1 January 20X1	43,125	
Trade receivables	28,750	
Cash in hand	4,600	
Purchases	258,750	
Bank interest	1,150	
Directors' remuneration	1,150	
Dividends	1,725	
Fees – audit	1,150	
Interest on debentures	6,325	
Insurance	3,450	
Salaries and wages	18,055	
Motor expenses	9,200	
Taxation	5,750	
Hire charges	300	
Light and power	920	
Miscellaneous expenses	275	
Stationery, courier	1,840	
Repairs and maintenance	2,760	
Sales		345,000
	539,925	539,925

8.2.9 Identify year end adjustments

The following information relating to accruals and prepayments has not yet been taken into account in the amounts shown in the trial balance:

- Inventory at cost at 31 December 20X1 was €25,875,000.
- Depreciation is to be provided as follows:
  – 2% on freehold buildings using the straight-line method;
  – 10% on equipment using the reducing balance method;
  – 25% on motor vehicles using reducing balance.
- €2,300,000 was prepaid for repairs and €5,175,000 has accrued for wages.
- Freehold buildings were revalued at €77,500,000.

8.2.10 Preparation of an internal statement of income after year end adjustments

A statement of income prepared for internal purposes is set out in Figure 8.2. We have arranged the expenses in descending monetary value. The method for doing this is not

Figure 8.2 Statement of income of Illustrious SpA for the year ended 31 December 20X1

		€000	€000
Sales			345,000
Less:			
Opening inventory		43,125	
Purchases		258,750	
		301,875	
Closing inventory		25,875	
Cost of sales			276,600
Gross profit			69,000
Less Expenses:			
Salaries and wages	W1	23,230	
Motor expenses		9,200	
Debenture interest		6,325	
Depreciation	W2	5,175	
Insurance		3,450	
Stationery, courier		1,840	
Fees – audit		1,150	
Bank interest		1,150	
Directors' remuneration		1,150	
Light and power		920	
Repairs and maintenance	W3	460	
Hire charges		300	
Miscellaneous expenses		275	
			54,625
Profit before tax			14,375
Taxation			5,750
Profit after tax			8,625
Dividends (are disclosed in Statement of Changes in Equity)			1,725
Retained earnings			6,900

prescribed and companies are free to organise the items in a number of ways, for example, listing in alphabetical order.

W1 Salaries and wages:

€18,055,000 + accrued €5,175,000 = €23,230,000

W2 Depreciation:

Buildings	2% of €57,500,000 = €1,150,000
Equipment	10% of (€14,950,000 − €3,450,000) = €1,150,000
Vehicles	25% of (€20,700,000 − €9,200,000) = €2,875,000
Total	= €5,175,000

W3 Repairs:

€2,760,000 − prepayment €2,300,000 = €460,000

8.2.11 An analysis of expenses by function

An analysis of expenses would be carried out in practice in order to classify these under their appropriate function heading. In the exercises that are set for classwork and examinations the expenses are often allocated rather than apportioned. For example, the insurance expense might be allocated in total to administration expense.

We have included apportionment in this example to give an understanding of the process that would occur in practice and is also met in some examination questions.

In order to analyse the costs, we need to consider each item in the detailed statement of income. Each item will be allocated to a classification or apportioned if it relates to more than one of the classifications. This requires the company to make a number of assumptions about the basis for allocating and apportioning. The process is illustrated in Figure 8.3.

Companies are required to be consistent in their treatment but we can see from the assumptions that have been made that costs may be apportioned differently by different companies.

8.2.12 Preparation of statement of comprehensive income – other comprehensive income

When IAS 1 was revised in 2008 the profit and loss account or 'income statement' was replaced by the statement of comprehensive income and a new section of 'Other comprehensive income' was added to the previous statement of income.

The recognised gains and losses reported as Other comprehensive income are gains and losses that were previously recognised directly in equity and presented in the statement of changes in equity. Such gains and losses arose, for example, from the revaluation of non-current assets and from other items that are discussed later in chapters on Financial Instruments and Employee Benefits e.g. equity investments held as Available-for-sale and Actuarial gains on defined benefit pension plans.

IAS 1 allows a choice in the way 'Other comprehensive income' is reported. It can be presented as a separate statement or as an extension of the Statement of income. In our example we have presented 'Other comprehensive income' as an extension of the Statement of income.

Figure 8.3 Assumptions made in analysing the costs

N1 An analysis of salaries and wages	*Total €000*	*Cost of sales €000*	*Distribution costs €000*	*Administration expenses €000*
Factory staff	12,075	12,075		
Warehouse staff and drivers	8,280		8,280	
Accounts department	575			575
Sales staff	2,300		2,300	
	23,230	12,075	10,580	575
N2 An analysis of depreciation				
Freehold buildings	1,150	575	287.5	287.5
Equipment	1,150	575	287.5	287.5
Motor vehicles (allocated)	2,875		2875	
	5,175	1,150	3,450	575
N3 An apportionment of operating expenses on the basis of space occupied				
Motor expenses (allocated)	9,200		9,200	
Insurance	3,450	1,725	862.5	862.5
Stationery, courier	1,840	920	460	460
Light and power	920	460	230	230
Repairs and maintenance	460	230	115	115
Hire charges	300	150	75	75
Miscellaneous expenses	275	137.5	68.75	68.75
	16,445	3,622.5	11,011.25	1,811.25
N4 Directors' remuneration and audit fees				
Audit fees	1,150			1,150
Directors' remuneration	1,150	575		575
	2,300	575		1,725
TOTAL (N1 + N2 + N£ + N4)	47,150	17,422.5	25,041.25	4,686.25
Add materials	276,000	276,000		
TOTALS for Statement of income	323,150	293,422.5	25,041.25	4,686.25

In this example, there is a revaluation surplus and this needs to be added to the profit on ordinary activities for the year in order to arrive at the comprehensive income. This is shown in Figure 8.4.

8.2.13 Presentation using IAS 1 Alternative method (Format 2)

If Format 2 is used, the expenses are classified as change in inventory, raw materials, employee benefits expense, other expenses and depreciation. The Statement of income reports the same operating profit as for Illustrious SpA.

Figure 8.4 Illustrious SpA statement of comprehensive income redrafted into Format 1 style

Statement of comprehensive income of Illustrious SpA for the year ended 31 December 20X1

	€000
Revenue	345,000.00
Cost of sales	293,422.50
Gross profit	51,577.50
Distribution costs	25,041.25
Administrative expenses	4,686.25
Operating profit	21,850.00
Finance costs	7,475.00
Profit on ordinary activities before tax	14,375.00
Taxation	5,750.00
Profit for the year	8,625.00
Other comprehensive income:	
Gains on property revaluation	20,000.00
Comprehensive income	28,625.00

Format 2	*€000*	*€000*
Revenue		345,000
Decrease in inventory	(17,250)	
Raw materials	(258,750)	(276,000)
Employee benefits expense		
Salaries	(23,230)	
Directors	(1,150)	(24,380)
Other expenses		
Motor expenses	(9,200)	
Insurance	(3,450)	
Stationery	(1,840)	
Audit fees	(1,150)	
Light and power	(920)	
Repairs	(460)	
Hire charges	(300)	
Miscellaneous	(275)	(17,595)
Depreciation	(5,175)	(5,175)
Operating profit		21,850

8.2.14 What information would be disclosed by way of note to the statement of comprehensive income?

There would be a note giving details of certain items that have been charged in arriving at the Operating Profit. These include items that are:

- sensitive, such as the makeup of the amounts paid to the auditors showing separately the audit fees and the non-audit fees such as for restructuring and for tax advice; and
- subject to judgement, such as the charges for depreciation; and

- exceptional, such as unusually high impairment of trade receivables. These should be disclosed separately either by way of note or on the face of the statement of comprehensive income if that degree of prominence is necessary in order to give a fair view.

For Illustrious SpA the note would read as follows:

Operating profit is stated after charging:

	€000
Depreciation	5,175

8.3 The prescribed formats – the statement of financial position

Let us now consider the prescribed formats for the statement of financial position, the accounting rules that govern the values at which the various assets are included in the statement and the explanatory notes that are required to accompany the statement.

8.3.1 The prescribed format

IAS 1 specifies which items are to be included on the face of the statement of financial position – these are referred to as alpha headings (a) to (r). It does not prescribe the order and presentation that is to be followed. It would be acceptable to present the statement as assets less liabilities equalling equity, or total assets equalling total equity and liabilities. The example given in IAS 1 follows the approach of total assets equalling total equity and liabilities.

The information that must be presented on the face of the statement is:

(a) Property, plant and equipment;

(b) Investment property;

(c) Intangible assets;

(d) Financial assets (excluding amounts shown under (e), (h) and (i));

(e) Investments accounted for using the equity method;

(f) Biological assets;

(g) Inventories;

(h) Trade and other receivables;

(i) Cash and cash equivalents;

(j) The total of assets classified as held for sale and assets included in disposal group classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*;

(k) Trade and other payables;

(l) Provisions;

(m) Financial liabilities (excluding amounts shown under (j) and (k));

(n) Liabilities and assets for current tax, as defined in IAS 12 *Income Taxes*;

(o) Deferred tax liabilities and deferred tax assets, as defined in IAS 12;

(p) Liabilities included in disposal groups classified as held for sale in accordance with IFRS 5;

(q) Non-controlling interests, presented within equity; and

(r) Issued capital and reserves attributable to equity holders of the parent.

IAS 1 does not absolutely prescribe that enterprises need to split assets and liabilities into current and non-current. However, it does state that this split would need to be done if the nature of the business indicates that it is appropriate. In almost all cases it would be appropriate to split items into current and non-current. If an enterprise decides that it is more relevant and reliable not to split the assets and liabilities into current and non-current on the face of the statement of financial position, they should be presented broadly in order of their liquidity. Not all headings will, of course, be applicable to all companies.

8.3.2 The accounting rules for asset valuation

International standards provide different valuation rules and some choice exists as to which rules to use. Many of the items in the financial statements are held at historical cost but variations to this principle may be required by different accounting standards. Some of the different bases are:

Property, plant and equipment	Can be presented at either historical cost or market value depending upon accounting policy chosen from IAS 16.[2]
Financial assets	Certain classes of financial asset are required to be recognised at fair value per IAS 39.[3]
Inventory	IAS 2 requires that this is included at the lower of cost and net realisable value.[4]
Provisions	IAS 37 requires the discounting to present value of some provisions.[5]

Illustrious SpA statement of financial position

The statement in Figure 8.5 follows the headings set out in para 8.3.1 above.

Figure 8.5 Illustrious SpA statement of financial position as at 31 December 20X1

	€000	*€000*	*€000*
Non-current assets			
Property, plant and equipment			152,825
Current assets			
Inventory	25,875		
Receivables	28,750		
Cash at bank and in hand	4,600		
Prepayments	2,300	61,525	
Current liabilities			
Payables	29,900		
Accruals	10,925		
Bank overdraft	8,625	49,450	
Net current assets			
Total assets less current liabilities			12,075
Non-current liabilities			164,900
Debentures			
			63,250
Equity			101,650
Share capital			
Reduction reserve			17,250
Retained earnings			20,000
			64,400
			101,650

8.3.3 What are the explanatory notes that accompany a statement of financial position?

We will consider (a) notes giving greater detail of the makeup of items that appear in the statement of financial position, (b) notes providing additional information to assist predicting future cash flows, and (c) notes giving information of interest to other stakeholders.

(a) Notes giving greater detail of the makeup of statement of financial position figures

Each of the alpha headings may have additional detail disclosed by way of a note to the accounts. For example, inventory of £25.875 million in the statement of financial position may have a note of its detailed makeup as follows:

	£m
Raw materials	11.225
Work-in-progress	1.500
Finished goods	13.150
	25.875

Property, plant and equipment normally has a schedule as shown in Figure 8.6. From this the net book value is read off the total column for inclusion in the statement of financial position.

(b) Notes giving additional information to assist prediction of future cash flows

These are notes intended to assist in predicting future cash flows. They give information on matters such as capital commitments that have been contracted for but not provided in the

Figure 8.6 Disclosure note: Property, plant and equipment movements

	Freehold Property €000	*Equipment €000*	*Motor Vehicles €000*	*Total €000*
Cost/valuation				
As at 1 January 20X1	115,000	14,950	20,700	150,650
Revaluation	20,000			20,000
Additions				
Disposals				
As at 31 December 20X1	135,000	14,950	20,700	170,650
Accumulated depreciation				
As at 1 January 20X1		3,450	9,200	12,650
Charge for the year	1,150	1,150	2,875	5,175
As at 31 December 20X1	1,150	4,600	12,075	17,825
Net book value				
As at 31 December 20X1	**133,850**	**10,350**	**8,625**	**152,825**
As at 31 December 20X0	115,000	11,500	11,500	138,000

accounts and capital commitments that have been authorised but not contracted for; future commitments, e.g. share options that have been granted; and contingent liabilities, e.g. guarantees given by the company in respect of overdraft facilities arranged by subsidiary companies or customers.

(c) Notes giving information that is of interest to other stakeholders

An example is information relating to staff. It is common for enterprises to provide a disclosure of the average number of employees in the period or the number of employees at the end of the period. IAS 1 does not require this information but it is likely that many businesses would provide and categorise the information, possibly following functions such as production, sales, administration. Suggested forms of presentation for Staff costs are shown in Figure 8.7.

Figure 8.7 Staff costs

Operating profit is stated after charging:

Staff costs	£xxx

The average number of employees during the period was as follows:

	Number employed
Production	XXX
Distribution	XXX
Sales	XXX
Research and development	XXX
Administration	XXX

This shows categorisation by function. Also acceptable would be categorisation by operating segment or no categorisation at all. However, because there is no standard form of presentation, it is not always sufficient for the prediction of cash flows if the costs are not analysed under function headings.

Employees themselves might be interested when, for example, attempting to assess a company's view that redundancies, short-time working and pay restrictions are actually necessary. The annual report is not the only source of information – there might be stand alone Employee Reports and information obtained during labour negotiations such as the ratio of short-term and long-term assets to employee, the capital–labour ratios and the average sales and net profits per employee in the company compared, if possible, to benchmarks from the same economic sector.

8.4 Statement of changes in equity

A primary statement called 'Statement of changes in equity' should be presented with the same prominence as the other primary statements. The statement is designed to show the comprehensive income for the period and the effects of any prior period adjustments, reconciling the movement in equity from the beginning to the end of the period. An entity must also disclose, either in the statement of changes in equity or in the notes, the amount of distributions to owners and the amount of dividends per share. The statement for Illustrious is shown in Figure 8.8.

Figure 8.8 Statement of Changes in Equity for the year ended 31 December 20X1

	Share capital	*Retained earnings*	*Revaluation Surplus*	*Total*
Balance as at 1 January 20X1	17,250	57,500		74,750
Changes in equity for 20X1				
Dividends		(1,725)		(1,725)
Total comprehensive income for the year	___	8,625	20,000	28,625
Balance as at 31 December 20X1	17,250	64,400	20,000	101,650

8.5 Has prescribing the formats meant that identical transactions are reported identically?

That is the intention, but there are various reasons why there may still be differences. For example, let us consider the Cost of sales figure. This figure is derived under the accrual accounting concept which means that:

(a) the cash flows have been adjusted by the management in order to match the expense that management considers to be associated with the sales achieved; and

(b) additional adjustments may have been made to increase the cost of sales, for example, if it is estimated that the net realisable value of the closing inventory is less than cost.

Clearly, when management adjust the cash flow figures they are exercising their judgement, and it is impossible to ensure that the management of two companies faced with the same economic activity would arrive at the same adjustment.

We will now consider some of reasons for differences in calculating the cost of sales – these are (a) how inventory is valued, (b) the choice of depreciation policy, (c) management attitudes and (d) the capability of the accounting system.

(a) Differences arising from the choice of the inventory valuation method

Different companies may assume different physical flows when calculating the cost of direct materials used in production. This will affect the inventory valuation. One company may assume a first-in-first-out (FIFO) flow, where the cost of sales is charged for raw materials used in production as if the first items purchased were the first items used in production. Another company may use an average basis.

This is illustrated in Figure 8.9 for a company that started trading on 1 January 20X1 without any opening inventory and sold 40,000 items on 31 March 20X1 for £4 per item.

Inventory valued on a FIFO basis is £60,000 with the 20,000 items in inventory valued at £3 per item, on the assumption that the purchases made on 1 January 20Xl and 1 February 20X1 were sold first. Inventory valued on an average basis is £40,000 with the 20,000 items in inventory valued at £2 per item on the assumption that sales made in March cannot be matched with a specific item.

The effect on the gross profit percentage would be as shown in Figure 8.10. This demonstrates that, even from a single difference in accounting treatment, the gross profit for the same transaction could be materially different in both absolute and percentage terms.

Figure 8.9 Effect on sales of using FIFO and weighted average

Physical flow assumption	Items	£	FIFO £	Average £
Raw materials purchased				
On 1 Jan 20X1 at £1 per item	20,000	20,000		
On 1 Feb 20X1 at £2 item	20,000	40,000		
On 1 Mar 20X1 at £3 per item	20,000	60,000		
On 1 Mar 20X1 in inventory	60,000	120,000	120,000	120,000
On 31 Mar 20X1 in inventory	20,000		60,000	40,000
Cost of sales	40,000		60,000	80,000

Figure 8.10 Effect of physical inventory flow assumptions on the percentage gross profit

	Items	FIFO £	Average £	% difference in gross profit
Sales	40,000	160,000	160,000	
Cost of sales	40,000	60,000	80,000	
		100,000	80,000	
Gross profit %		62.5%	50%	25%

How can the investor determine the effect of different assumptions?

Although companies are required to disclose their inventory valuation policy, the level of detail provided varies and we are not able to quantify the effect of different inventory valuation policies.

For example, a clear description of an accounting policy is provided by AstraZeneca in Figure 8.11. Even so, it does not allow the user to know how net realisable value was determined. Was it, for example, primarily based upon forecasted short-term demand for the product?

Figure 8.11 AstraZeneca inventory policy (2009) annual report

Inventories

Inventories are stated at the lower of cost or net realisable value. The first in, first out or an average method of valuation is used. For finished goods and work in progress, cost includes directly attributable costs and certain overhead expenses (including depreciation). Selling expenses and certain other overhead expenses (principally central administration costs) are excluded. Net realisable value is determined as estimated selling price less all estimated costs of completion and costs to be incurred in selling and distribution.

Write downs of inventory occur in the general course of business and are included in cost of sales in the income statement.

While we can carry out academic exercises as in Figure 8.10 and we are aware of the effect of different inventory valuation policies on the level of profits, it is not possible to carry out such an exercise in real life.

(b) Differences arising from the choice of depreciation method and estimates

Companies may make different choices:

- the accounting base to use e.g. historical cost or revaluation; and
- the method that is used to calculate the charge e.g. straight-line or reducing balance.

Companies make estimates that might differ:

- assumptions as to an asset's productive use, e.g. different estimates made as to the economic life of an asset; and
- assumptions as to the total cost to be expensed, e.g. different estimates of the residual value.

(c) Differences arising from management attitudes

Losses might be anticipated and measured at a different rate. For example, when assessing the likelihood of the net realisable value of inventory falling below the cost figure, the management decision will be influenced by the optimism with which it views the future of the economy, the industry and the company. There could also be other influences. For example, if bonuses are based on net income, there is an incentive to over-estimate the net realisable value; whereas, if management are preparing a company for a management buy-out, there is an incentive to underestimate the net realisable value in order to minimise the net profit for the period.

(d) Differences arising from the capability of the accounting system to provide data

Accounting systems within companies differ. Costs collected by one company may well not be collected by another company. Also the apportionment of costs might be more detailed with different proportions being allocated or apportioned.

8.5.1 Does it really matter under which heading a cost is classified in the statement of comprehensive income provided it is not omitted?

The gross profit figure is a measure of production efficiency and it will be affected if costs are allocated (or not) to cost of sales from one of the other expense headings.

When comparing a company's performance care is needed to see how the profit used by the management in their Financial Highlights is selected. For example, in the 2010 financial statements of the ITOCHU Corporation the Gross trading profit is used:

	1st Half FY 2010	*1st Half FY 2009*	*Increase (Decrease)*	*%*	*Outlook for FY 2010*	*Progress(%)*
Net income attributable to ITOCHU	55.3	139.1	(83.8)	(60.2%)	130.0	42.6%
Revenue	1,651.0	1,496.7	154.3	10.3%		
Gross trading profit	440.0	542.1	(102.1)	(18.8%)	950.0	46.3%

The decreases in their Textile and Machinery business was explained as follows:

Textile	Due to market slowdown in textile materials, fabrics, apparels despite increase from an acquisition of SANKEI CO., LTD.
Machinery	Due to reduced transactions in automobile and construction machinery business, and decrease in sales volume by the absence of ship trading transactions in the previous 1st H.

In the 2008 Wolseley Annual Report, however, the profit used is Trading profit defined as Operating profit before exceptional items and the amortisation and impairment of acquired intangibles. The choice might be consistent or it might be to emphasise that exceptional items and amortisation charges have a material impact on the Trading profit, for example, the effect on Wolseley is to reduce its trading profit by more than 50%.

8.6 The fundamental accounting principles underlying statements of comprehensive income and statements of financial position

IAS 1 (paras 15–46) requires compliance with the fundamental accounting principles such as accruals, materiality and aggregation, going concern and consistency of presentation.

A concept not specifically stated in IAS 1 is prudence, which is an important principle in the preparation of financial statements. The *Framework* states that reliable information in the financial statements must be prudent[6] and this implies that a degree of caution should be exercised in making judgements or estimates. Prudence does not allow the making of excessive or unnecessary provisions that would deliberately understate net assets and therefore render the financial statements unreliable.

8.6.1 Disclosure of accounting policies

The accounting policies adopted can make a significant difference to the financial statements. It is important for investors to be aware of the policies and to be confident that management will not change them on an *ad hoc* basis to influence the results. IAS 1 (para. 10) therefore requires a company to state the accounting policies adopted by the company in determining the amounts shown in the Statements of comprehensive income and financial position and to apply them consistently. We have already illustrated above the effect of choosing different inventory valuation policies and the effect if a company were not consistent.

8.7 What is the difference between accounting principles, accounting bases and accounting policies?

Accounting principles

All companies are required to comply with the broad accounting principles of going concern, consistency, accrual accounting, materiality and aggregation. If they fail to comply, they must disclose, quantify and justify the departure from the principle.

Accounting bases

These are the methods that have been developed for applying the accounting principles. They are intended to restrict the subjectivity by identifying a range of acceptable methods. For example, assets may be valued according to the historical cost convention or the alternative accounting rules. Bases have been established for a number of assets, e.g. non-current assets and inventories.

Figure 8.12 Extract from the financial statements of the Nestlé Group

Property, Plant and Equipment

Property, plant and equipment are shown in the statement of financial position at their historical cost. Depreciation is provided on components that have homogeneous useful lives by using the straightline method so as to depreciate the initial cost down to the residual value over the estimated useful lives. The residual values are 30% on head office, 20% on distribution centres for products stored at ambient temperature and nil for all other asset types.

The useful lives are as follows:

Buildings	20–35 years
Machinery and equipment	10–20 years
Tools, furniture, information technology and sundry equipment	3–8 years
Vehicles	5 years
Land is not depreciated	

Useful lives, components and residual amounts are reviewed annually. Such a review takes into consideration the nature of the assets, their intended use and the evolution of technology.

Depreciation of property, plant and equipment is allocated to the appropriate headings of expenses by function in the statement of comprehensive income. Financing costs incurred during the course of construction are expenses. Premiums capitalized for leasehold land and buildings are amortised over the length of the lease.

Accounting policies

Accounting policies are chosen by a company as being the most appropriate to the company's circumstances and **best able to produce a fair view**. They typically disclose the accounting policies followed for the basis of accounting, i.e. historical or alternative accounting rules, and asset valuation, e.g. for inventory, stating whether it uses FIFO or other methods and for property, plant and equipment, stating whether depreciation is straight-line or another method.

As an example, there might be a detailed description as shown by the Nestlé Group in Figure 8.12 or a more general description as shown in the AstraZeneca policy statement in Figure 8.13.

8.7.1 How do users know the effect of changes in accounting policy?

Accounting policies are required by IAS 1 to be applied consistently from one financial period to another. It is only permissible to change an accounting policy if required by a Standard or if the directors consider that a change results in financial statements that are reliable and more relevant. When a change occurs IAS 8 requires:

- the comparative figures of the previous financial period to be amended if possible;
- the disclosure of the reason for the change, the effect of the adjustment in the statement of comprehensive income of the period and the effect on all other periods presented with the current period financial statements.

Figure 8.13 Extract from the financial statements of AstraZeneca

> **Property, Plant and Equipment**
> The Group's policy is to write off the difference between the cost of each item of property, plant and equipment and its residual value systematically over its estimated useful life. Assets under construction are not depreciated.
>
> Reviews are made annually of the estimated remaining lives and residual values of individual productive assets, taking account of commercial and technological obsolescence as well as normal wear and tear. Under this policy it becomes impractical to calculate average asset lives exactly. However, the total lives range from approximately thirteen to fifty years for buildings, and three to fifteen years for plant and equipment. All items of property, plant and equipment are tested for impairment when there are indications that the carrying value may not be recoverable. Any impairment losses are recognised immediately in the income statement.

8.7.2 What is meant by a fair view?

This may be referred to as giving a fair presentation or a true and fair view.

8.7.3 IAS 1 requirements – fair presentation

IAS 1 requires financial statements to give a fair presentation of the financial position, financial performance and cash flows of an enterprise. In para. 17 it states that:

> In virtually all circumstances, a fair presentation is achieved by compliance with applicable IFRSs. A fair presentation also requires an entity:
>
> **(a)** to select and apply accounting policies in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of a Standard or an Interpretation that specifically applies to an item;
>
> **(b)** to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
>
> **(c)** to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

8.7.4 True and fair view

The Companies Act 2006 requires financial statements to give a true and fair view. Auditors are required to give an opinion on true and fair.

8.7.5 Legal opinions – true and fair

True and fair is a legal concept and can be authoritatively decided only by a court. However, the courts have never attempted to define 'true and fair'. In the UK the Accounting Standards Committee (ASC) obtained a legal opinion which included the following statements:

> It is however important to observe that the application of the concept involves **judgement in questions of degree**. The information contained in the accounts must be accurate and comprehensive to within acceptable limits. What is acceptable and how is this to be achieved?
>
> Reasonable businessmen and accountants may differ over the degree of accuracy or comprehensiveness which in particular cases the accounts should attain.
>
> Equally, there may sometimes be **room for differences over the method** to adopt in order to give a true and fair view, cases in which there may be more than one true and fair view of the same financial position.
>
> Again, because true and fair involves questions of degree, we think **that cost effectiveness must play a part** in deciding the amount of information which is sufficient to make accounts true and fair.
>
> Accounts will not be true and fair unless the information they contain is **sufficient in** quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed.[7]

A further counsel's opinion was attained by the Accounting Standards Board (ASB) in 1991 and published[8] in its foreword to Accounting Standards. It advised that accounting standards are an authoritative source of accounting practice and it is now the norm for financial statements to comply with them. In consequence the court may take accounting standards into consideration when forming an opinion on whether the financial statements give a true and fair view.

However, an Opinion obtained by the FRC in May 2008 advised that true and fair still has to be taken into consideration by preparers and auditors of financial statements. Directors have to consider whether the statements are appropriate and auditors have to exercise professional judgement when giving an audit opinion – it is not sufficient for either directors or auditors to reach a conclusion solely because the financial statements were prepared in accordance with applicable accounting standards.

8.7.6 Fair override

IAS 1 recognises that there may be occasions when application of an IAS might be misleading and departure from IAS treatment is permitted. This is referred to as the fair override provision. If a company makes use of the override it is required to explain why compliance with IASs would be misleading and also give sufficient information to enable the user to calculate the adjustments required to comply with the standard.

The true and fair concept is familiar to the UK and Netherlands accounting professions. Many countries, however, view the concept of the true and fair view with suspicion since it runs counter to their legal systems. In Germany the fair override provision has not been directly implemented and laws are interpreted according to their function and objectives. It appears that the role of true and fair in the European context is to act as a protection against over-regulation. Since the wider acceptance of IASs has been occurring in recent years, the financial statements of many more companies and countries are fulfilling the principle of a true and fair view.

Although IAS 1 does not refer to true and fair, the International Accounting Standards Regulation 1606/2002 (para. 9) states that: 'To adopt an international accounting standard for application in the Community, it is necessary . . . that its application results in a true and fair view of the financial position and performance of an enterprise'.

When do companies use the fair override?

It can occur for a number[9] of reasons:

- Accounting standards may prescribe one method, which contradicts company law and thus requires an override, e.g. providing no depreciation on investment properties.
- Accounting standards may offer a choice between accounting procedures, at least one of which contradicts company law. If that particular choice is adopted, the override should be invoked, e.g. grants and contributions not shown as deferred income.

  An example of this is shown in the extract from the 2005 Annual Report of Severn Trent:

  Grants and contributions
  Grants and contributions received in respect of non infrastructure assets are treated as deferred income and are recognised in the profit and loss account over the useful economic life of those assets. In accordance with industry practice, grants and contributions relating to infrastructure assets have been deducted from the cost of fixed assets.

  This is not in accordance with Schedule 4 to the Act, which requires assets to be shown at their purchase price or production cost and hence grants and contributions to be presented as deferred income. This departure from the requirements of the Act is, in the opinion of the Directors, necessary to give a true and fair view as, while a provision is made for depreciation of infrastructure assets, finite lives have not been determined for these assets, and therefore no basis exists on which to recognise grants or contributions as deferred income. The effect of this departure is that the cost of fixed assets is £398.5 million lower than it would otherwise have been (2004: £362.6 million).

  Those grants and contributions relating to the maintenance of the operating capability of the infrastructure network are taken into account in determining the depreciation charged for infrastructure assets.

- Accounting standards may allow some choice but prefer a particular method which is consistent with company law, but the alternative may not be consistent, e.g. not amortising goodwill (prior to IAS requirement for impairment review).
- There may be a legal requirement but no accounting standard. Failure to comply with the law would require a True and Fair override, e.g. current assets being reported at market value rather than at cost.
- There may be an accounting standards requirement which is overridden, e.g. not providing depreciation on non-current assets.

8.7.7 Fair override can be challenged

Although companies may decide to adopt a policy that is not in accordance with IFRS and rely on the fair override provision, this may be challenged by the Financial Reporting Review Panel and the company's decision overturned, e.g. although Eurovestech had adopted an accounting policy in its 2005 and 2006 accounts not to consolidate two of its subsidiaries because its directors considered that to do so would not give a true and fair view, the FRRP decision was that this was unacceptable because the company was unable to demonstrate special circumstances warranting this treatment.

8.8 What does an investor need in addition to the financial statements to make decisions?

Investors attempt to estimate future cash flows when making an investment decision. As regards future cash flows, these are normally perceived to be influenced by past profits, the asset base as shown by the statement of financial position and any significant changes.

In order to assist shareholders to predict future cash flows with an understanding of the risks involved, more information has been required by the IASB. This has taken two forms:

- more quantitative information in the accounts, including:
  - segmental analysis;
  - the impact of changes on the operation, e.g. a breakdown of turnover, costs and profits for both new and discontinued operations;
  - and the existence of related parties (these are discussed in the next chapter); and
- more qualitative information, including:
  - Mandatory disclosures;
  - Chairman's report;
  - Directors' report;
  - Best practice disclosures: Operating and Financial Review;
  - Business Review in the Directors' report.

We will comment briefly on the qualitative disclosures.

8.8.1 Mandatory disclosures

When making future predictions investors need to be able to identify that part of the net income that is likely to be maintained in the future. IAS 1 provides assistance to users in this by requiring that certain items are separately disclosed. These are items within the ordinary activities of the enterprise which are of such size, nature or incidence that their separate disclosure is required in the financial statements in order for the financial statements to show a fair view.

These items are not extraordinary and must, therefore, be presented above the tax line. It is usual to disclose the nature and amount of these items in a note to the financial statements, with no separate mention on the face of the statement of comprehensive income; however, if sufficiently material, they can be disclosed on the face of the statement.

Examples of the type of items[10] that may give rise to separate disclosures are:

- the write-down of assets to realisable value or recoverable amount;
- the restructuring of activities of the enterprise, and the reversal of provisions for restructuring;
- disposals of items of property, plant and equipment;
- disposals of long-term investments;
- discontinued operations;
- litigation settlements;
- other reversals of provisions.

8.8.2 Additional qualitative information – Chairman's Report

This often tends to be a brief upbeat comment on the current year. For example, the following is a brief extract from Findel plc's 2008 annual report to illustrate the type of information provided.

> Sales from ongoing businesses in our Home Shopping division increased by 22% to £403.5m (2007: £330.7m) with benchmark operating profit increasing to £50.3m (2007: £47.6m). The Home Shopping division now comprises a number of leading brands, each with its own unique appeal and market. Statutory sales for the Home Shopping division were £409.8m (2007: £368.3m) with statutory operating profit of £41.0m (2007: £19.2m).
>
> 2007/08 was the first full trading year for our cash with order division in which it generated £137.5m in sales with net operating margins of 7%. We experienced strong sales growth from Kitbag as it launched three more Premier League football club sites and moved into cricket, rugby, motorsport and tennis. We also benefited from a particularly good profit performance from Kleeneze following its integration into our Accrington site.
>
> The main feature in the year for the cash with order brands was their relocation and integration. This was a huge undertaking and inevitably created some distraction, although we are pleased with the results.

8.8.3 Directors' Report

The paragraph headings from Findel's 2008 annual report illustrate the type of information that is published. The report headings were:

- Activities
- Review of the year and future prospects
- Dividends
- Capital structure
- Suppliers' payment policy
- Directors
- Employees
- Substantial holdings
- Auditors.

There is a brief comment under each heading, for example:

> **Activities**
> The principal activities of the Group are home shopping and educational supplies through mail order catalogues and the provision of outsourced healthcare services.
>
> **Review of the Year and Future Prospects**
> The key performance indicators which management consider important are:
>
> - operating margins
> - average order value
> - retention rates in Home Shopping
> - on-time collections and deliveries within Healthcare.

8.8.4 OFR Reporting Standard RS 1

The ASB published RS 1 in 2005. This is not a statutory Standard and is intended to inform best practice. The intention was that directors should focus on the information needs specific to their company and its shareholders rather than follow a rigid list of items to be disclosed. RS 1 assisted directors in this approach by setting down certain principles and providing illustrations of Key Performance Indicators.

The OFR's guiding principles

The seven principles were that the OFR should:

1. reflect the directors' view of the business;
2. focus on matters that are relevant to investors in assessing the strategies adopted and the potential for those strategies to succeed. Whilst maintaining the primacy of meeting investors' needs, directors should take a 'broad view' in deciding what should be included in their OFR, on the grounds that the decisions and agendas of other stakeholders can influence the performance and value of a company;
3. have a forward-looking orientation with an analysis of the main trends and factors which are likely to affect the entity's future development, performance and position;
4. complement as well as supplement the financial statements with additional explanations of amounts included in the financial statements;
5. be comprehensive and understandable but avoid the inclusion of too much information that is not directly relevant;
6. be balanced and neutral – in this way the OFR can produce reliable information;
7. be comparable over time – the ability to compare with other entities in the same industry or sector is encouraged.

Key performance indicators (KPIs)

There has been a concern that OFR would lack quantifiable information. This was addressed with a list of potentially useful KPIs. These covered a wide range of interests including:

- Economic measures of ability to create value (with the terms defined)
  - Return on capital employed

    Capital employed defined for example as Intangible assets + property, plant and equipment + investments + accumulated goodwill amortisation + inventories + trade accounts receivable + other assets including prepaid expenses
  - Economic profit type measures

    Economic profit = Profit after tax and non-controlling interests, excluding goodwill amortisation – cost of capital
- Market positioning
  - Market position
  - Market share

    Market share, being company revenue over estimated market revenue
- Development, performance and position
  - A number of the measures used to monitor the development, performance and position of the company may be traditional financial measures

    - Cash conversion rate: rate at which profit is converted into cash
    - Asset turnover rates
  - Directors often supplement these with other measures common to their industry to monitor their progress towards stated objectives, e.g.
    - Average revenue per user (customer)
    - Number of subscribers
    - Sales per square foot
    - Percentage of revenue from new products
    - Number of products sold per customer
    - Products in the development pipeline
    - Cost per unit produced
- Persons with whom the entity has relations and which could have a significant impact
  - Customers: how do they view the service provided?
    - Measure customer retention
  - Employees: how do they feel about the company?
    - Employee satisfaction surveys
    - Health and safety measures
  - Suppliers: how do they view the company?
  - Regulators: how do they view the company?
- Environmental matters
  - Quantified measures of water and energy usage
- Social and community issues
  - Public health issues, such as obesity, perceived safety issues related to high use of mobile phones
  - Social risks existing in the supply chain such as the use of child labour and payment of fair wages
  - Diversity in either the employee or customer base
  - Impact on the local community, e.g. noise, pollution, transport congestion
  - Indigenous and human rights issues relating to communities local to overseas operations
  - Receipts from and payments to shareholders
  - Other resources
  - Brand strength
  - Intellectual property
  - Intangible assets.

8.8.5 Additional qualitative information – Business Review in the Directors' Report

This is a requirement in the UK. The intention is that the Review should provide a balanced and comprehensive analysis of the business including social and environmental aspects to allow shareholders to assess how directors have performed their statutory duty to promote the company's success. The government is taking the view that matters required by the Reporting Statement such as 'Trends and factors affecting the development, performance and position of the business and KPIs' would be required to be included in the Business Review *where necessary*, i.e. in those circumstances where it were thought to be necessary in order to provide a balanced and comprehensive analysis of the development, performance and position of the business, or describe the principal risks and uncertainties facing the business. It could well be that in practice companies will satisfy the requirements of the Reporting Statement and include within the Business Review a cut-down version of that information.

8.8.6 ASB review of narrative reporting

In 2006 the ASB (www.accountancyfoundation.com/asb/press/pub1228.html) carried out reviews of narrative reporting by FTSE 100 companies. It identified that there was good reporting of descriptions of their business and markets, strategies and objectives and the current development and performance of the business and an increase in companies providing environmental and social information.

However, it also identified the need for improvement in identifying Key financial and non-financial Performance Indicators; describing off-balance sheet positions and the principal risks with an explanation as to how these will be managed.

As far as forward-looking information was concerned, it might well be that the protection offered by the safe harbour provisions in the Companies Act 2006 could encourage companies to avoid choosing to make bland statements that are of little use to shareholders. The safe harbour provisions protect directors from civil liability in respect of omissions or statements made in the narrative reports unless the omissions were to dishonestly conceal material information or the statements were untrue or misleading and made recklessly or in bad faith.

8.8.7 How decision-useful is the statement of comprehensive income?

IAS 1 now requires a statement of comprehensive income as a primary financial statement. There has been ongoing discussion as to the need for such a statement. Some commentators[11] argue that there is no decision-usefulness in providing the comprehensive net income figure for investors whereas others[12] take the opposite view. Intuitively, one might take a view that investors are interested in the total movement in equity regardless of the cause which would lead to support for the comprehensive income figure. However, given that there is this difference of opinion and research findings, this would seem to be an area open to further empirical research to further test the decision-usefulness of each measure to analysts.

Interesting research[13] has since been carried out which supports the view that Net Income and Comprehensive Income are both decision-useful. The findings suggested that comprehensive income was more decision-relevant for assessing share returns and traditional net income more decision-relevant for setting executive bonus incentives.

Summary

In order to assess stewardship and management performance, there have been mandatory requirements for standardised presentation, using formats prescribed by International Financial Reporting Standards. There have also been mandatory requirements for the disclosure of accounting policies, which allow shareholders to make comparisons between years.

There is an increasing pressure for additional disclosures such as KPIs and improved narrative reporting to help users assess the stewardship and assist in making predictions as to future cash flows.

REVIEW QUESTIONS

1 Explain why two companies carrying out identical trading transactions could produce different gross profit figures.

2 A statement of comprehensive income might contain the following profit figures:

Gross profit
Profit from operations
Profit before tax
Net profit from ordinary activities
Net profit for the period.

Explain when you would use each profit figure for analysis purposes, e.g. profit from operations may be used in the percentage return on capital employed.

3 Classify the following items into cost of sales, distribution costs, administrative expenses, other operating income or item to be disclosed after trading profit:

(a) Personnel department costs
(b) Computer department costs
(c) Cost accounting department costs
(d) Financial accounting department costs
(e) Bad debts
(f) Provisions for warranty claims
(g) Interest on funds borrowed to finance an increase in working capital
(h) Interest on funds borrowed to finance an increase in property plant and equipment.

4 'We analyze a sample of UK public companies that invoked a TFV override during 1998–2000 to assess whether overrides are used opportunistically. We find overrides increase income and equity significantly, and firms with weaker performance and higher levels of debt employ overrides that are more costly . . . financial statements are not less informative than control sample.'[14]

Discuss the enquiries and action that you think an auditor should take to ensure that the financial statements give a more true and fair view than from applying standards.

5 When preparing accounts under Format 1, how would a bad debt that was materially larger than normal be disclosed?

6 'Annual accounts have been put into such a straitjacket of overemphasis on uniform disclosure that there will be a growing pressure by national bodies to introduce changes unilaterally which will again lead to diversity in the quality of disclosure. This is both healthy and necessary.' Discuss.

7 Explain the relevance to the user of accounts if expenses are classified as 'administrative expenses' rather than as 'cost of sales'.

8 IAS 1 *Presentation of Financial Statements* requires 'other comprehensive income' items to be included in the statement of comprehensive income and it also requires a statement of changes in equity.

Explain the need for publishing this information, and identify the items you would include in them.

EXERCISES

An extract from the solution is provided on the Companion Website (www.pearsoned.co.uk/elliott-elliott) for exercises marked with an asterisk (*).

Question 1

Basalt plc is a wholesaler. The following is its trial balance as at 31 December 20X0.

	Dr	*Cr*
	£000	*£000*
Ordinary share capital: £1 shares		300
Share premium		20
General reserve		16
Retained earnings as at 1 January 20X0		55
Inventory as at 1 January 20X0	66	
Sales		962
Purchases	500	
Administrative costs	10	
Distribution costs	6	
Plant and machinery – cost	220	
Plant and machinery – provision for depreciation		49
Returns outwards		25
Returns inwards	27	
Carriage inwards	9	
Warehouse wages	101	
Salesmen's salaries	64	
Administrative wages and salaries	60	
Hire of motor vehicles	19	
Directors' remuneration	30	
Rent receivable		7
Trade receivables	326	
Cash at bank	62	
Trade payables		66
	1,500	1,500

The following additional information is supplied:

(i) Depreciate plant and machinery 20% on straight-line basis.

(ii) Inventory at 31 December 20X0 is £90,000.

(iii) Accrue auditors' remuneration £2,000.

(iv) Income tax for the year will be £58,000 payable October 20X1.

(v) It is estimated that 7/11 of the plant and machinery is used in connection with distribution, with the remainder for administration. The motor vehicle costs should be allocated to distribution.

Required:

Prepare a statement of income and statement of financial position in a form that complies with IAS 1. No notes to the accounts are required.

* Question 2

The following trial balance was extracted from the books of Old NV on 31 December 20X1.

	€000	€000
Sales		12,050
Returns outwards		313
Provision for depreciation		
Plant		738
Vehicles		375
Rent receivable		100
Trade payables		738
Debentures		250
Issued share capital – ordinary €1 shares		3,125
Issued share capital – preference shares (treated as equity)		625
Share premium		350
Retained earnings		875
Inventory	825	
Purchases	6,263	
Returns inwards	350	
Carriage inwards	13	
Carriage outwards	125	
Salesmen's salaries	800	
Administrative wages and salaries	738	
Land	100	
Plant (includes €362,000 acquired in 20X1)	1,562	
Motor vehicles	1,125	
Goodwill	1,062	
Distribution costs	290	
Administrative expenses	286	
Directors' remuneration	375	
Trade receivables	3,875	
Cash at bank and in hand	1,750	
	19,539	19,539

Note of information not taken into the trial balance data:

(a) Provide for:
   (i) An audit fee of €38,000.
   (ii) Depreciation of plant at 20% straight-line.
   (iii) Depreciation of vehicles at 25% reducing balance.
   (iv) The goodwill suffered an impairment in the year of €177,000.
   (v) Income tax of €562,000.
   (vi) Debenture interest of €25,000.

(b) Closing inventory was valued at €1,125,000 at the lower of cost and net realisable value.

(c) Administrative expenses were prepaid by €12,000.

(d) Land was to be revalued by €50,000.

Required:

(a) Prepare a statement of income for internal use for the year ended 31 December 20X1.

(b) Prepare a statement of comprehensive income for the year ended 31 December 20X1 and a statement of financial position as at that date in Format 1 style of presentation.

Question 3

HK Ltd has prepared its draft trial balance to 30 June 20X1, which is shown below.

Trial balance at 30 June 20X1

	$000	$000
Freehold land	2,100	
Freehold buildings (cost $4,680)	4,126	
Plant and machinery (cost $3,096)	1,858	
Fixtures and fittings (cost $864)	691	
Goodwill	480	
Trade receivables	7,263	
Trade payables		2,591
Inventory	11,794	
Bank balance	11,561	
Development grant received		85
Profit on sale of freehold land		536
Sales		381,600
Cost of sales	318,979	
Administration expenses	9,000	
Distribution costs	35,100	
Directors' emoluments	562	
Bad debts	157	
Auditors' remuneration	112	
Hire of plant and machinery	2,400	
Loan interest	605	
Dividends paid during the year – preference	162	
Dividends paid during the year – ordinary	426	
9% loan		7,200
Share capital – preference shares (treated as equity)		3,600
Share capital – ordinary shares		5,400
Retained earnings		6,364
	407,376	407,376

The following information is available:

(a) The authorised share capital is 4,000,000 9% preference shares of $1 each and The authorised share capital is 4,000,000 9% preference shares of $1 each and 18,000,000 ordinary shares of 50c each.

(b) Provide for depreciation at the following rates:

(i) Plant and machinery 20% on cost
(ii) Fixtures and fittings 10% on cost
(iii) Buildings 2% on cost

Charge all depreciation to cost of sales.

(c) Provide $5,348,000 for income tax.

(d) The loan was raised during the year and there is no outstanding interest accrued at the year-end.

(e) Government grants of $85,000 have been received in respect of plant purchased during the year and are shown in the trial balance. One-fifth is to be taken into profit in the current year.

(f) During the year a fire took place at one of the company's depots, involving losses of $200,000. These losses have already been written off to cost of sales shown in the trial balance. Since the end of the financial year a settlement of $150,000 has been agreed with the company's insurers.

(g) $500,000 of the inventory is obsolete. This has a realisable value of $250,000.

(h) Acquisitions of property, plant and equipment during the year were:

Plant	$173,000	Fixtures	$144,000

(i) During the year freehold land which cost $720,000 was sold for $1,316,000.

(j) A final ordinary dividend of 3c per share is declared and was an obligation before the year-end, together with the balance of the preference dividend. Neither dividend was paid at the year-end.

(k) The goodwill has not been impaired.

(l) The land was revalued at the year end at $2,500,000.

Required:

(a) Prepare the company's statement of comprehensive income for the year to 30 June 20X1 and a statement of financial position as at that date, complying with the relevant accounting standards in so far as the information given permits.
(All calculations to nearest $000.)

(b) Explain the usefulness of the schedule prepared in (b).

Question 4

Phoenix plc trial balance at 30 June 20X7 was as follows:

	£000	*£000*
Freehold premises	2,400	
Plant and machinery	1,800	540
Furniture and fittings	620	360
Inventory at 30 June 20X7	1,468	
Sales		6,465
Administrative expenses	1,126	
Ordinary shares of £1 each		4,500
Trade investments	365	
Revaluation reserve		600
Development cost	415	
Share premium		500
Personal ledger balances	947	566
Cost of goods sold	4,165	
Distribution costs	669	
Overprovision for tax		26
Dividend received		80
Interim dividend paid	200	
Retained earnings		488
Disposal of warehouse		225
Cash and bank balances	175	

The following information is available:

1 Freehold premises acquired for £1.8 million were revalued in 20X4, recognising a gain of £600,000. These include a warehouse, which cost £120,000, was revalued at £150,000 and was sold in June 20X7 for £225,000. Phoenix does not depreciate freehold premises.

2 Phoenix wishes to report Plant and Machinery at open market value which is estimated to be £1,960,000 on 1 July 20X6.

3 Company policy is to depreciate its assets on the straight-line method at annual rates as follows:

Plant and machinery	10%
Furniture and fittings	5%

4 Until this year the company's policy has been to capitalise development costs, to the extent permitted by relevant accounting standards. The company must now write off the development costs, including £124,000 incurred in the year, as the project no longer meets the capitalisation criteria.

5 During the year the company has issued one million shares of £1 at £1.20 each.

6 Included within administrative expenses are the following:

Staff salary (including £125,000 to directors)	£468,000
Directors' fees	£96,000
Audit fees and expenses	£86,000

7 Income tax for the year is estimated at £122,000.

8 Directors propose a final dividend of 4p per share declared and an obligation, but not paid at the year-end.

Required:

In respect of the year ended 30 June 20X7:

(a) The statement of comprehensive income.

(b) The statement of financial position as at 30 June 20X7.

(c) The statement of movement of property, plant and equipment.

Question 5

The following is an extract from the trial balance of Imecet at 31 October 2005:

	$000	$000
Property valuation	8,000	
Factory at cost	2,700	
Administration building at cost	1,200	
Delivery vehicles at cost	500	
Sales		10,300
Inventory at 1 November 2004	1,100	
Purchases	6,350	
Factory wages	575	
Administration expenses	140	
Distribution costs	370	
Interest paid (6 months to 30 April 2005)	100	
Accumulated profit at 1 November 2004		3,701
10% Loan stock		2,000
$1 Ordinary shares (incl. issue on 1 May 2005)		4,000
Share premium (after issue on 1 May 2005)		1,500
Dividends (paid 1 June 2005)	400	
Revaluation reserve		2,500
Deferred tax		650

Other relevant information:

(i) One million $1 Ordinary shares were issued 1 May 2005 at the market price of $1.75 per ordinary share.

(ii) The inventory at 31 October 2005 has been valued at $1,150,000.

(iii) A current tax provision for $350,000 is required for the period ended 31 October 2005 and the deferred tax liability at that date has been calculated to be $725,000.

(iv) The property has been further revalued at 31 October 2005 at the market price of $9,200,000.

(v) No depreciation charges have yet been recognised for the year ended 31 October 2005.

The depreciation rates are:

Factory – 5% straight-line.
Administration building – 3% straight-line.
Delivery vehicles – 25% reducing balance. The accumulated depreciation at 31 October 2004 was $10,000. There were no new vehicles acquired in the year to 31 October 2005.

Required:

(a) Prepare the Income Statement for Imecet for the year ended 31 October 2005.

(b) Prepare the statement of changes in equity for Imecet for the year ended 31 October 2005.

(The Association of International Accountants)

* Question 6

Olive A/S, incorporated with an authorised capital consisting of one million ordinary shares of €1 each, employs 646 persons, of whom 428 work at the factory and the rest at the head office. The trial balance extracted from its books as at 30 September 20X4 is as follows:

	€000	€000
Land and buildings (cost €600,000)	520	—
Plant and machinery (cost €840,000)	680	—
Proceeds on disposal of plant and machinery	—	180
Fixtures and equipment (cost €120,000)	94	—
Sales	—	3,460
Carriage inwards	162	—
Share premium account	—	150
Advertising	112	—
Inventory on 1 Oct 20X3	211	—
Heating and lighting	80	—
Prepayments	115	—
Salaries	820	—
Trade investments at cost	248	—
Dividend received (net) on 9 Sept 20X4	—	45
Directors' emoluments	180	—
Pension cost	100	—
Audit fees and expense	65	—
Retained earnings b/f	—	601
Sales commission	92	—
Stationery	28	—
Development cost	425	—
Formation expenses	120	—
Receivables and payables	584	296
Interim dividend paid on 4 Mar 20X4	60	—
12% debentures issued on 1 Apr 20X4	—	500
Debenture interest paid on 1 Jul 20X4	15	—
Purchases	925	—
Income tax on year to 30 Sept 20X3	—	128
Other administration expenses	128	—
Bad debts	158	—
Cash and bank balance	38	—
Ordinary shares of €1 fully called	—	600
	5,960	5,960

You are informed as follows:

(a) As at 1 October 20X3 land and buildings were revalued at €900,000. A third of the cost as well as all the valuation is regarded as attributable to the land. Directors have decided to report this asset at valuation.

(b) New fixtures were acquired on 1 January 20X4 for €40,000; a machine acquired on 1 October 20X1 for €240,000 was disposed of on 1 July 20X4 for €180,000, being replaced on the same date by another acquired for €320,000.

(c) Depreciation for the year is to be calculated on the straight-line basis as follows:

Buildings: 2% p.a.
Plant and machinery: 10% p.a.
Fixtures and equipment: 10% p.a.

(d) Inventory, including raw materials and work-in-progress on 30 September 20X4, has been valued at cost at €364,000.

(e) Prepayments are made up as follows:

	€000
Amount paid in advance for a machine	60
Amount paid in advance for purchasing raw materials	40
Prepaid rent	15
	€115

(f) In March 20X3 a customer had filed legal action claiming damages at €240,000. When accounts for the year ended 30 September 20X3 were finalised, a provision of €90,000 was made in respect of this claim. This claim was settled out of court in April 20X4 at €150,000 and the amount of the underprovision adjusted against the profit balance brought forward from previous years.

(g) The following allocations have been agreed upon:

	Factory	*Administration*
Depreciation of buildings	60%	40%
Salaries other than to directors	55%	45%
Heating and lighting	80%	20%

(h) Pension cost of the company is calculated at 10% of the emoluments and salaries.

(i) Income tax on 20X3 profit has been agreed at €140,000 and that for 20X4 estimated at €185,000. Corporate income tax rate is 35% and the basic rate of personal income tax 25%.

(j) Directors wish to write off the formation expenses as far as possible without reducing the amount of profits available for distribution.

Required:
Prepare for publication:
(a) The Statement of Comprehensive Income of the company for the year ended 30 September 20X4, and
(b) the Statement of Financial Position as at that date along with as many notes (other than the one on accounting policy) as can be provided on the basis of the information made available.
(c) the Statement of Changes in Equity.

Question 7

Raffles Ltd trades as a wine wholesaler with a large warehouse in Asia. The trainee accountant at Raffles Ltd has produced the following draft accounts for the year ended 31 December 20X6.

Statement of comprehensive income

	$
Sales	1,628,000
Less: Cost of sales	1,100,000
Gross profit	528,000
Debenture interest paid	9,000
Distribution costs	32,800
Audit fees	7,000
Impairment of goodwill	2,500
Income tax liability on profits	165,000
Interim dividend	18,000
Dividend received from Diat P'or plc	(6,000)
Bank interest	3,000
Over provision of income tax in prior years	(4,250)
Depreciation	
Land and buildings	3,000
Plant and machinery	10,000
Fixtures and fittings	6,750
Administrative expenses	206,300
Net profit	74,900

Draft statement of financial position at 31 December 20X6

	$		$
Bank balance	12,700	Inventory	156,350
10% debentures 20X9	180,000	Receivables	179,830
Ordinary share capital		Land and buildings	238,000
50c nominal value	250,000	Plant and machinery	74,000
Trade payables	32,830	Fixtures and fittings	20,250
Income tax			
Creditor	165,000	Goodwill	40,000
Retained earnings	172,900	Investments at cost	130,000
Revaluation reserve	25,000		
	838,430		838,430

The following information is relevant:

1 The directors maintain that the investments in Diat P'or plc will be held by the company on a continuing basis and that the current market value of the investments at the period end was $135,000. However, since the period end there has been a substantial fall in market prices and these investments are now valued at $90,000.

2 The authorised share capital of Raffles Ltd is 600,000 ordinary shares.

3 During the year the company paid shareholders the proposed 20X5 final dividend of $30,000. This transaction has already been recorded in the accounts.

4 The company incurred $150,000 in restructuring costs during the year. These have been debited to the administrative expenses account. The trainee accountant subsequently informs you that tax relief of $45,000 will be given on these costs and that this relief has not yet been accounted for in the records.

5 The company employs an average of ten staff, 60% of whom work in the wine purchasing and importing department, 30% in the distribution department and the remainder in the accounts department. Staff costs total $75,000.

6 The company has three directors. The managing director earns $18,000 while the purchasing and distribution directors earn $14,000 each. In addition the directors receive bonuses and pensions of $1,800 each. All staff costs have been debited to the statement of comprehensive income.

7 The directors propose to decrease the bad debt provision by $1,500 as a result of the improved credit control in the company in recent months.

8 Depreciation policy is as follows:

Land and buildings:	No depreciation on land. Buildings are depreciated over 25 years on a straight-line basis. This is to be charged to cost of sales.
Plant and machinery:	10% on cost, charge to cost of sales.
Fixtures and fittings:	25% reducing balance, charge to administration.

9 The directors have provided information on a potential lawsuit. A customer is suing them for allegedly tampering with the imported wine by injecting an illegal substance to improve the colour of the wine. The managing director informs you that this lawsuit is just 'sour grapes' by a jealous customer and provides evidence from the company solicitor which indicates that there is only a small possibility that the claim for $8,000 will succeed.

10 Purchased goodwill was acquired in 20X3 for $50,000. The annual impairment test revealed an impairment of $2,500 in the current year.

11 Plant and machinery of $80,000 was purchased during the year to add to the $20,000 plant already owned. Fixtures and fittings acquired two years ago with a net book value of $13,500 were disposed of. Accumulated depreciation of fixtures and fittings at 1 January 20X6 was $37,500.

12 Land was revalued by $25,000 by Messrs Moneybags, Chartered Surveyors, on an open market value basis, to $175,000 during the year. The revaluation surplus was credited to the revaluation reserve. There is no change in the value of the buildings.

13 Gross profit is stated after charging $15,000 relating to obsolete cases of wine that have 'gone off'. Since that time an offer has been received by the company for its obsolete wine stock of $8,000, provided the company does additional vinification on the wine at a cost of $2,000 to bring it up to the buyer's requirements. A cash discount of 5% is allowed for early settlement and it is anticipated that the buyer will take advantage of this discount.

14 Costs of $10,000 relating to special plant and machinery have been included in cost of sales in error. This was not spotted until after the production of the draft accounts.

Required:

(a) Prepare a statement of comprehensive income for the year ended 31 December 20X6 and a statement of financial position at that date for presentation to the members of Raffles Ltd in accordance with relevant accounting standards.

(b) Produce detailed notes to both statements of Raffles Ltd for the year ended 31 December 20X6.

Question 8

Graydon Ross CFO of Diversified Industries PLC is discussing the publication of the annual report with his managing director Phil Davison. Graydon says: 'The law requires us to comply with accounting standards and at the same time to provide a true and fair view of the results and financial position. As half of the business consists of the crockery and brick making business which your great great grandmother started, and the other half is the insurance company which your father started, I am not sure that the consolidated accounts are very meaningful. It is hard to make sense of any of the ratios as you don't know what industry to compare them with. What say we also give them the comprehensive income statements and balance sheets of the two subsidiary companies as additional information, and then no one can complain that they didn't get a true and fair view?'

Phil says: 'I don't think we should do that. The more information they have the more questions they will ask. Also they might realise we have been smoothing income by changing our level of pessimism in relation to the provisions for outstanding insurance claims. Anyway I don't want them to interfere with my business. Can't we just include a footnote, preferably a vague one, that stresses we are not comparable to either insurance companies or brick makers or crockery manufacturers because of the unique mix of our businesses? Don't raise the matter with the auditors because it will put ideas into their heads. But if it does come up we may have to charge head office costs to the two subsidiaries. You need to think up some reason why most of the charges should be passed on to the crockery operations. We don't want to show everyone how profitable that area is. I trust you will give that some thought so you will have a good answer ready.'

Required:
Discuss the professional, legal and ethical implications for Ross.

References

1 IAS 1, *Presentation of Financial Statements*, December 2008.
2 IAS 16 *Property, Plant and Equipment*, IASC, revised 1998, paras 28–29.
3 IAS 39 *Financial Instruments: Recognition and Measurement*, IASC, 1998, para. 69.
4 IAS 2 *Inventories*, IASC, revised 1993, para. 6.
5 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IASC, 1998, para. 45.
6 *Framework for the Preparation and Presentation of Financial Statements*, IASC, 1989, para. 46.
7 K. Wild and A. Guida, *Touche Ross Financial Reporting Manual* (3rd edition), Butterworth, 1990, p. 433.
8 K. Wild and C. Goodhead, *Touche Ross Financial Reporting Manual* (4th edition), Butterworth, 1994, p. 5.
9 LBS Accounting Subject Area Working Paper No. 031 *An Empirical Investigation of the True and Fair Override*, Gilad Livne and Maureen McNichols (www.bm.ust.hk/acct/acsymp2004/Papers/Livne.pdf).
10 IAS 1, para. 86.
11 D. Dhaliwal, K. Subramnayam and R. Trezevant, 'Is comprehensive income superior to net income as a measure of firm performance?', *Journal of Accounting and Economics*, 26:1, 1999, pp. 43–67.
12 D. Hirst and P. Hopkins, 'Comprehensive income reporting and analysts' valuation judgments', *Journal of Accounting Research*, 36 (Supplement), 1998, pp. 47–74.
13 G.C. Biddles and Jong-Hag Choi, 'Is comprehensive income irrelevant?', 12 June 2002. Available at SSRN: http://ssrn.com/abstract=316703.
14 G. Livne and M.F. McNichols, 'An empirical investigation of the true and fair override', *Journal of Business, Finance and Accounting*, pp. 1–30, January/March 2009.