ALAN MELVILLE

Fourth Edition

INTERNATIONAL FINANCIAL REPORTING

A Practical Guide

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International Financial Reporting

A Practical Guide

Fourth Edition

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Preface

The aim of this book is to explain International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs) at a level which is appropriate for students who are undertaking an intermediate course of study in financial reporting. It is assumed that the reader has already completed an introductory accounting course and is familiar with the basics of financial accounting. The book has not been written with any particular syllabus in mind but should be useful to second-year undergraduates studying for a degree in accounting and finance and to those who are preparing for the examinations of the professional accounting bodies.

IFRSs and IASs (referred to in this book as "international standards") have gained widespread acceptance around the world and most accounting students are now required to become familiar with them. The problem is that the standards and their accompanying documents comprise over 3,000 pages of fine print and much of this content is highly technical and difficult to understand. What is needed is a textbook which explains the main features of each standard as clearly and concisely as possible and provides students with plenty of worked examples and exercises. This book tries to satisfy that need.

The standards are of international application but, for the sake of convenience, most of the monetary amounts referred to in the worked examples and exercises in this book are denominated in £s. Other than this, the book contains very few UK-specific references and should be relevant in any country which has adopted international standards.

Each chapter of the book concludes with a set of exercises which test the reader's grasp of the topics introduced in that chapter. Some of these exercises are drawn from the past examination papers of professional accounting bodies. Solutions to most of the exercises are located at the back of the book but solutions to those exercises which are marked with an asterisk (*) are intended for lecturers' use and are provided on a supporting website.

This fourth edition is in accordance with all international standards or amendments to standards issued as at 1 January 2013.

Alan Melville
April 2013

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I would like to thank the International Financial Reporting Standards Foundation for permission to use extracts from various IASB standards (Copyright © IFRS Foundation. All rights reserved. Reproduced by Pearson Education Limited with the permission of the IFRS Foundation ®. No permission granted to third parties to reproduce or distribute). The IASB, the IFRS Foundation, the authors and the publishers do not accept responsibility for any loss caused by acting or refraining from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

I would also like to thank the following accounting bodies for granting me permission to use their past examination questions:

- Association of Chartered Certified Accountants (ACCA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)
- Association of Accounting Technicians (AAT).

I must emphasise that the answers provided to these questions are entirely my own and are not the responsibility of the accounting body concerned. I would also like to point out that the questions which are printed in this textbook have been amended in some cases so as to reflect changes in accounting standards which have occurred since those questions were originally published by the accounting body concerned.

Please note that, unless material is specifically cited with a source, any company names used within this text have been created by me and are intended to be fictitious.

Alan Melville
April 2013

List of international standards

A full list of the International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs) which are in force at the time of writing this book is given below. Standards missing from the list have been withdrawn. Alongside each standard is a cross-reference to the chapter of the book in which that standard is explained.

It is important to realise that new or modified standards are issued fairly often. The reader who wishes to keep up-to-date is advised to consult the website of the International Accounting Standards Board (IASB) at www.ifrs.org.

International Financial Reporting Standards (IFRSs)		*Chapter*
IFRS 1	First-time Adoption of International Financial Reporting Standards	1
IFRS 2	Share-based Payment	–
IFRS 3	Business Combinations	6
IFRS 4	Insurance Contracts	–
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	8
IFRS 6	Exploration for and Evaluation of Mineral Resources	–
IFRS 7	Financial Instruments: Disclosures	11
IFRS 8	Operating Segments	24
IFRS 9	Financial Instruments	11
IFRS 10	Consolidated Financial Statements	18
IFRS 11	Joint Arrangements	20
IFRS 12	Disclosure of Interests in Other Entities	18, 20
IFRS 13	Fair Value Measurement	5
IFRS for SMEs	Small and Medium-sized Entities	25
International Accounting Standards (IASs)		
IAS 1	Presentation of Financial Statements	3
IAS 2	Inventories	10
IAS 7	Statement of Cash Flows	16
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	4
IAS 10	Events after the Reporting Period	12
IAS 11	Construction Contracts	10

IAS 12	Income Taxes	15
IAS 16	Property, Plant and Equipment	5
IAS 17	Leases	9
IAS 18	Revenue	13
IAS 19	Employee Benefits	14
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	5
IAS 21	The Effects of Changes in Foreign Exchange Rates	21
IAS 23	Borrowing Costs	5
IAS 24	Related Party Disclosures	21
IAS 26	Accounting and Reporting by Retirement Benefit Plans	–
IAS 27	Separate Financial Statements	18
IAS 28	Investments in Associates and Joint Ventures	20
IAS 29	Financial Reporting in Hyperinflationary Economies	17
IAS 32	Financial Instruments: Presentation	11
IAS 33	Earnings per Share	23
IAS 34	Interim Financial Reporting	3
IAS 36	Impairment of Assets	7
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	12
IAS 38	Intangible Assets	6
IAS 39	Financial Instruments: Recognition and Measurement	11
IAS 40	Investment Property	5
IAS 41	Agriculture	–

It should be noted that some of these standards are beyond the scope of this book and are considered no further here. These are IFRS2, IFRS4, IFRS6, IAS26 and IAS41.

As well as the international standards, two further IASB documents (neither of which is a standard) are dealt with in this book. These are:

(a) the *Conceptual Framework for Financial Reporting* (see Chapter 2) which sets out a number of concepts that underlie financial reporting and which is referred to by the IASB during the development of new and amended standards

(b) an IFRS Practice Statement entitled *Management Commentary* (see Chapter 3) which provides a non-binding framework for the presentation of a management commentary to accompany a set of financial statements.

Part 1

INTRODUCTION TO FINANCIAL REPORTING

Chapter 1

The regulatory framework

Introduction

Financial reporting is the branch of accounting that deals with the preparation of financial statements. These statements provide information about the financial performance and financial position of the business to which they relate and may be of value to a wide range of user groups. More specifically, the term "financial reporting" is most often used to refer to the preparation of financial statements for a limited company. In this case, the main users of the statements are the company's shareholders. However, the information which is contained in financial statements may also be of use to other user groups such as lenders, employees and the tax authorities (see Chapter 2).

The purpose of this book is to explain the rules which govern the preparation of financial statements for organisations which comply with international standards. This first chapter introduces the *regulatory framework* within which financial statements are prepared. The next chapter outlines the main features of a *conceptual framework* setting out the main concepts which underlie financial reporting.

Objectives

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

- list the main sources of accounting regulations and explain the need for regulation
- explain the term "generally accepted accounting practice" (GAAP)
- outline the structure and functions of the International Accounting Standards Board (IASB) and its associated bodies
- explain the purpose of an accounting standard and list the main steps in the standard-setting process adopted by the IASB
- outline the structure of an international financial reporting standard or international accounting standard
- explain the main features of IFRS1 *First-time Adoption of International Financial Reporting Standards*.

The need for regulation

Small business organisations are usually managed by their owners. This is generally the case for a sole trader, where the business is run by a single owner-manager, and for partnerships, where the business is owned and managed by its partners. Similarly, small private limited companies are often managed by their shareholders, who might all be members of the same family. In these circumstances, the owner or owners of the business can glean considerable amounts of financial information from their day-to-day involvement in managing its affairs and so do not depend solely upon formal financial statements to provide them with this information.

In contrast, large businesses (which are usually limited companies) are generally owned by one group of people but are managed by a different group. A large public company is owned by its shareholders, of whom there may be many thousands, but is managed by a small group of directors. Although some of the shareholders may also act as directors, it is likely that the large majority of the shareholders have no direct involvement in managing the company which they own. Such shareholders are almost entirely reliant upon the company's financial statements for information regarding the company's financial performance and position and to help them to determine whether or not the company is being properly managed. Other external user groups (such as the company's creditors) are also dependent to a large extent upon the information contained in financial statements when trying to make economic decisions relating to the company.

If the form and content of financial statements were not regulated, it would be possible for incompetent or unscrupulous directors to provide shareholders and other users with financial statements which gave a false or misleading impression of the company's financial situation. This would inevitably cause users to make poor economic decisions and so undermine the whole purpose of preparing financial statements. Therefore it is vital, especially in the case of larger companies, that financial reporting should be subject to a body of rules and regulations.

Sources of regulation

The rules and regulations which apply to financial reporting may be collectively referred to as the "regulatory framework". In practice, most of this framework applies only to companies, but it is important to realise that financial reporting regulations could be made in relation to any class of business entity. Indeed, the international standards which are the subject of this book generally refer to "entities" rather than companies. However, it may be assumed for the remainder of the book that we are dealing primarily with financial reporting by companies. The regulatory framework which applies to financial reporting by companies consists of the following main components:

(a) legislation
(b) accounting standards

(c) stock exchange regulations.

Each of these is explained below.

Legislation

Most of the developed countries of the world have enacted legislation which governs financial reporting by limited companies. This legislation does of course differ from one country to another. In the UK, for example, the Companies Act 2006 contains rules relating to matters such as:

- the accounting records which companies must keep
- the requirement to prepare annual accounts (i.e. financial statements)
- the requirement that these accounts must give a "true and fair view"
- the requirement that the accounts must be prepared in accordance with either international standards or national standards
- the circumstances in which group accounts must be prepared (see Chapter 18)
- the circumstances in which an audit is required
- the company's duty to circulate its accounts to shareholders and to make the accounts available for public inspection.

Some of these rules have arisen as a result of European Union (EU) Directives and this is also true of the legislation in other member states of the EU.

Accounting standards

Whilst legislation generally sets out the broad rules with which companies must comply when preparing financial statements, detailed rules governing the accounting treatment of transactions and other items shown in those statements are laid down in *accounting standards*. Many of the developed countries of the world have their own standard-setting bodies, each of which is responsible for devising and publishing accounting standards for use in the country concerned. In the UK this is the Accounting Standards Board (ASB). The USA has a Financial Accounting Standards Board (FASB) and there are standards boards in other countries such as Germany, Japan, Australia etc.

In recent years, the increasing globalisation of business has fuelled the search for a single set of accounting standards. These standards would apply throughout the world and would greatly improve the consistency of financial reporting. To this end, the International Accounting Standards Board (IASB) has developed and is continuing to develop a set of international standards which it hopes will attain global acceptance. These standards are already used in a great many countries of the world (see later in this chapter) and a major step forward in this process was taken when the EU issued a regulation requiring all listed companies in the EU to prepare their group accounts (see Chapter 18) in accordance with international standards as from 1 January 2005.

Most of the remainder of this book is concerned with the international standards and an introduction to the work of the IASB is given later in this chapter.

Stock exchange regulations

A company whose shares are listed (or "quoted") on a recognised stock exchange must comply with the regulations of that stock exchange, some of which may relate to the company's financial statements. A stock exchange may, for example, require its member companies to produce financial statements more frequently than required by law (e.g. to publish interim financial reports at quarterly or half-yearly intervals) or to provide a more detailed analysis of some of the items in its financial statements than is required by law or by accounting standards.

Generally accepted accounting practice

The term "generally accepted accounting practice" (GAAP) refers to the complete set of regulations from all sources which apply within a certain jurisdiction, together with any general accounting principles or conventions which are usually applied in that jurisdiction even though they may not be enshrined in regulations. Since accounting rules and regulations currently differ from one country to another, it is correct to use terms such as "UK GAAP", "US GAAP" and so forth. At present, there is no internationally accepted set of accounting regulations and principles but the IASB is working towards that end and is trying to achieve convergence between the various regulations which are in force throughout the world (see later in this chapter). A distinction is sometimes drawn between big GAAP and little GAAP, as follows:

(a) The term "big GAAP" refers to the accounting regulations which apply to large companies (generally listed companies). The financial affairs of these companies can be very complex and therefore the regulations which comprise big GAAP need to be correspondingly complex. Some of the international standards described in this book appear to have been written mainly with large companies in mind.

(b) The term "little GAAP" refers to the simpler accounting regulations which apply to smaller companies. In the UK, for example, small companies may choose to adopt the *Financial Reporting Standard for Smaller Entities* issued by the UK Accounting Standards Board, rather than complying with UK accounting standards in full.

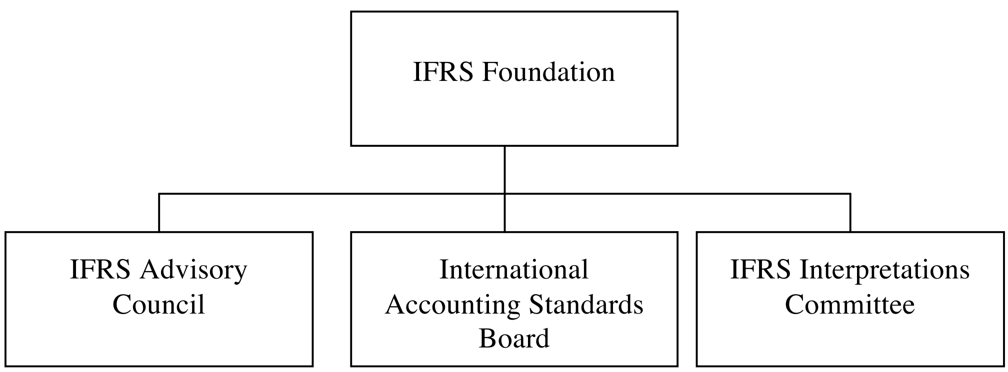
    At the international level, the International Accounting Standards Board has issued the *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*). This is essentially a simplified version of the full international standards and is intended for use mainly by unlisted companies (see Chapter 25).

The International Accounting Standards Board

International standards are developed and published by the International Accounting Standards Board (IASB) which was formed in 2001 as a replacement for the International Accounting Standards Committee (IASC). Standards published by the IASB are known as International Financial Reporting Standards (IFRSs). Standards which were originally published by the IASC are known as International Accounting Standards (IASs). Many of these IASs are still in force, since they were adopted by the IASB on its inception. At present, the list of extant standards comprises thirteen IFRSs and twenty-eight IASs. A full list of these standards is given at the front of this book.

The IASB consists of sixteen members, of whom up to three may be part-time. The members of the IASB are chosen for their professional competence and their practical experience and are selected in such a way that a broad geographical balance is maintained on the Board. The current IASB Chairman is Hans Hoogervorst. The previous Chairman was Sir David Tweedie, who occupied the position for ten years and was formerly Chairman of the UK Accounting Standards Board.

The IASB is responsible to the trustees of the International Financial Reporting Standards Foundation (IFRS Foundation) as shown in the following diagram:



The IFRS Foundation

The constitution of the IFRS Foundation states that its objectives are as follows:

(a) to develop, in the public interest, a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, participants in the world's capital markets and other users of financial information to make economic decisions;

(b) to promote the use and rigorous application of those standards;

(c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings;

(d) to promote and facilitate adoption of International Financial Reporting Standards (IFRSs), being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

The IASB's *Preface to International Financial Reporting Standards* states that these are also the objectives of the IASB.

The activities of the IFRS Foundation are directed by twenty-two Trustees who are appointed subject to approval by a Monitoring Board (see below) and who are drawn from a diversity of geographical and professional backgrounds. The Trustees are responsible for appointing the members of the IASB and the other bodies shown in the above diagram and for establishing and maintaining the necessary funding for their work. The Trustees are also responsible for reviewing the effectiveness of the IASB. Financial support for the IFRS Foundation's activities is received from a variety of sources, including:

(a) national financing regimes based upon a country's Gross Domestic Product (GDP)

(b) income from publications and related activities

(c) major international accounting firms.

The Monitoring Board comprises high-level representatives of public authorities such as the European Commission and the US Securities and Exchange Commission. The Trustees are required to make an annual written report to the Monitoring Board.

The IFRS Advisory Council

The IFRS Advisory Council provides a forum for participation by organisations and individuals with an interest in international financial reporting. The Advisory Council comprises thirty or more members drawn from diverse geographical and functional backgrounds and has the following objectives:

(a) to offer advice to the IASB with regard to its agenda and priorities

(b) to inform the IASB of Council members' views on standard-setting projects

(c) to offer other advice to the IASB or to the Trustees.

The Chairman of the Advisory Council cannot be a member of the IASB or its staff.

The IFRS Interpretations Committee

The main role of the IFRS Interpretations Committee is to interpret the application of international standards and to provide timely guidance on financial reporting matters which are not specifically addressed in the standards. The Interpretations Committee has fourteen voting members and a non-voting Chair.

The standard-setting process

The IASB develops standards by means of a "due process" which involves accountants, users of financial statements, the business community, stock exchanges, regulatory authorities, academics and other interested individuals and organisations throughout the world. The main steps in this process (which are listed in the *Preface to International Financial Reporting Standards*) are as follows:

- identification and review of all the issues associated with the topic concerned
- consideration of the way in which the IASB's conceptual framework (see Chapter 2) applies to these issues
- a study of national accounting requirements in relation to the topic and an exchange of views with national standard-setters
- consultation with the Trustees and the Advisory Council about the advisability of adding this topic to the IASB's agenda
- publication of a discussion document for public comment
- consideration of comments received within the stated comment period
- publication of an exposure draft for public comment
- consideration of comments received within the stated comment period
- publication of the standard.

Publication of an international standard requires the approval of at least ten of the sixteen members of the IASB.

The *Preface* states that IFRSs and IASs are designed to apply to the general purpose financial statements and other financial reporting of profit-oriented entities, whether these are organised in corporate form or in other forms. For this reason, the standards refer to "entities" rather than companies. The word "entity" is also used in this book, although in practice the international standards apply principally to companies.

The structure of an international standard

An IFRS or IAS consists of a set of numbered paragraphs and is typically made up of some or all of the following sections:

- introduction
- objectives and scope of the standard
- definitions of terms used in the standard (these may be in an Appendix)
- the body of the standard
- effective date and transitional provisions
- approval by the IASB and any dissenting opinions by IASB members.

A standard may be accompanied by a Basis for Conclusions, which is not part of the standard itself but which sets out the considerations which were taken into account when the standard was devised. There may also be application or implementation guidance and illustrative examples.