Master of Commerce Batch 2018 Onwards
MCOPAF 311-18
International Accounting

Course Objectives: The aim of this course is to enable the students to learn international accounting concepts, practices, and issues in the global financial environment. It focuses on the accounting issues encountered by multinational companies engaged in international trade and invested in foreign operations.

UNIT-I

Introduction to International Accounting Worldwide Accounting Diversity International Convergence of Financial Reporting. Causes of International Differences – Some major differences in Financial Reporting .International Financial Reporting Standards. The nature and operations of the IASB Structure of the IFRSF/IASB, Extant standards of the IASB, The framework.

UNIT-II

International Taxation International Transfer Pricing. IFRS 10, Consolidated Financial Statements; IAS 27 (revised 2011), Separate financial statements IFRS 3, Business Combinations IAS 28 (revised 2011), Investments in associates and joint ventures.

UNIT-III

IFRS 11, Joint arrangements; IFRS 12, Disclosure of interests in other entities; IAS 21, The effects of changes in foreign exchange rates. Foreign Currency Transactions and Hedging Foreign Exchange Risk Translation of Foreign Currency Financial Statements.

UNIT-IV

Strategic Accounting Issues in MNCs International Corporate Social Reporting. Comparison of Accounting Standards Principal differences between US GAAP and IFRS. IFRS's road map ahead for convergence, First time adoption of IFRS. Ethical issues in international Accounting – Incidence and implications of window dressing.

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Unit - 1

Introduction to International Accounting

International accounting, which includes both managerial and financial accounting, is accounting for international transactions, the operations of international firms, and comparisons of accounting principles and practices found in foreign lands and the procedures by which they are established. International accounting is a well-established specialty area within accounting and has two major dimensions:

1**. Comparative—**examining how and why accounting principles differ from country to country

2. **Pragmatic—**accounting for the operational problems and issues encountered by individuals and firms in international business

Convergence of IFRS:

Countries may deviate from IFRS issued by IASB to certain extent. Deviation can be change of terminology used, modifying principles for recognizing assets, liabilities, income or expense, addition or deletion of disclosures (considering the local law of the country applying IFRS), addition or deletion of examples.

Logic of applying IFRS after applying convergence is that there can be many regulators of a country and in case the rules and regulations of any law or Act of are in conflict of IFRS, it will create chaos in corporate reporting. Hence, Ind AS are substantially similar to the IFRS but with some carve outs to ensure that these standards are suitable for application in the environment of the country opting for convergence.

Next topic:

EVIDENCE OF ACCOUNTING DIVERSITY

Some of the differences in accounting that exist across countries can be categorized in the following manner:

1. Differences in the financial statements included in an annual report.
2. Differences in the format used to present individual financial statements.
3. Differences in the level of detail provided in the financial statements.
4. Terminology differences.
5. Disclosures differences.
6. Recognition and measurement differences.

REASONS FOR ACCOUNTING DIVERSITY

Why do financial reporting practices differ across countries? Accounting scholars have hypothesized numerous influences on a country's accounting system, including factors as varied as the nature of the political system, the stage of economic development, and the state of accounting education and research. A survey of the relevant literature has identified the following five items as being commonly accepted as factors influencing a country's financial reporting practices: legal system, taxation, providers of financing, inflation, and political and economic ties.

1. Legal System

There are two major types of legal systems used around the world: common law and codified Roman law.
Common law began in England and is primarily found in the English-speaking countries of the world. Common law countries rely on a limited amount of statute law, which is then interpreted by the courts. Court decisions establish precedents, thereby developing case law that supplements the statutes. A system of code law, followed in most non-English-speaking countries, originated in the Roman just civiler and was developed further in European universities during the Middle Ages.

Code law countries tend to have relatively more statute or codified law governing a wider range of human activity. Code law countries generally have corporation law (sometimes called a commercial code or companies act), which establishes the basic legal parameters governing business enterprises. The corporation law often stipulates which financial statements must be published in accordance with a prescribed format. Additional accounting measurement and disclosure rules are included in an accounting law debated and passed by the national legislature.

In countries where accounting rules are legislated, the accounting profession tends to have little influence on the development of accounting standards. In countries with a tradition of common law, although a corporation law laying the basic framework for accounting might exist (such as in the United Kingdom), specific accounting rules are established by the profession or by an independent nongovernmental body representing a variety of constituencies. Thus, the type of legal system in a country tends to determine whether the primary source of accounting rules is the government or a nongovernmental organization.

In code law countries, the accounting law tends to be rather general and does not provide much detail regarding specific accounting practices and may provide no guidance at all in certain areas. Germany is a good example of this type of country. The German accounting law passed in 1985 is only 47 pages long and is silent with regard to issues such as leases, foreign currency translation, and cash flow statements.

When no guidance is provided in the law, German companies refer to other sources, including tax law, opinions of the German auditing profession, and standards issued by the German Accounting Standards Committee, to decide how to do their accounting. Interestingly enough, important sources of accounting practice in Germany have been textbooks and commentaries written by accounting academicians.

In common law countries, where there is likely to be a non-legislative organization developing accounting standards, much more detailed rules are developed. In Nigeria, we used to have the Nigerian Accounting Standards Board (NASB), which has been replaced by the Financial Reporting Council of Nigeria (FRCN); while they have the Financial Accounting Standards Board (FASB) in the United States, which provides a substantial amount of implementation guidance in its accounting standards codification (ASC) and updates.

2. Taxation

In some countries, published financial statements form the basis for taxation, whereas in other countries, financial statements are adjusted for tax purposes and submitted to the government separately from the reports sent to stockholders. Continuing to focus on Germany, the so-called congruency principle in that country stipulates that the published financial statements serve as the basis for taxable income. In most cases, for an expense to be deductible for tax purposes it must also be used in the calculation of financial statement income. Well-managed German companies attempt to minimize income for tax purposes, for example, through the use of accelerated depreciation, so as to reduce their tax liability. As a result of the congruency principle, accelerated depreciation must also be taken in the calculation of accounting income. In the United States, in contrast, conformity between the tax statement and financial statements is required only with regard to the use of the last-in, first-out (LIFO) inventory cost flow assumption. U.S. companies are allowed to use accelerated depreciation for tax purposes and straight-line depreciation in the financial statements. All else being equal, because of the influence of the congruency principle, a German company is likely to report lower income than its U.S. counterpart. The difference between tax and accounting income gives rise to the necessity to account for deferred income taxes, a major issue in the United States as well as in Nigeria. Deferred income taxes are much less of an issue in Germany; for many German companies, they do not exist at all. This is also true in other code law countries such as France and Japan.

3. Providers of Financing

The major providers of financing for business enterprises are family members, banks, governments, and shareholders. In those countries in which company financing is dominated by families, banks, or the state, there will be less pressure for public accountability and information disclosure. Banks and the state will often be represented on the board of directors and will therefore be able to obtain information necessary for decision making from inside the company. As companies become more dependent on financing from the general populace through the public offering of shares of stock, the demand for more information made available outside the company becomes greater. It simply is not feasible for the company to allow the hundreds, thousands, or hundreds of thousands of shareholders access to internal accounting records. The information needs of those financial statement users can be satisfied only through extensive disclosures in accounting reports. There can also be a difference in financial statement orientation, with stockholders more interested in profit (emphasis on the income statement) and banks more interested in solvency and liquidity (emphasis on the balance sheet). Bankers tend to prefer companies to practice rather conservative accounting with regard to assets and liabilities.

4. Inflation

Countries experiencing chronic high rates of inflation found it necessary to adopt accounting rules that required the inflation adjustment of historical cost amounts. This was especially true in Latin America, which as a region has had more inflation than any other part of the world. For example, throughout the 1980s and 1990s, the average annual rate of inflation rate in Mexico was approximately 50 percent, with a high of 159 percent in 1987. Double- and triple-digit inflation rates render historical costs meaningless. Throughout most of the latter half of the 20th century, this factor primarily distinguished Latin America from the rest of the world with regard to accounting. Adjusting accounting records for inflation results in a write-up of assets and therefore related expenses. Adjusting income for inflation is especially important in those countries in which accounting statements serve

as the basis for taxation; otherwise, companies will be paying taxes on fictitious profits.

5. **Political and Economic Ties**
   Accounting is a technology that can be relatively easily borrowed from or imposed on another country. Through political and economic links, accounting rules have been conveyed from one country to another. For example, through previous colonialism, both England and France have transferred their accounting frameworks to a variety of countries around the world. British-style accounting systems can be found in countries as far-flung as Australia and Zimbabwe. French accounting is prevalent in the former French colonies of western Africa. More recently, it is thought that economic ties with the United States have had an impact on accounting in Canada, Mexico, and Israel.

6. **Correlation of Factors**

   Whether by coincidence or not, there is a high degree of correlation between legal system, tax conformity, and source of financing. Common law countries tend to have greater numbers of domestic listed companies, relying more heavily on equity as a source of capital. Code law countries tend to link taxation to accounting statements and rely less on financing provided by shareholders.

PROBLEMS CAUSED BY ACCOUNTING DIVERSITY

1. **Preparation of Consolidated Financial Statements**

   The diversity in accounting practice across countries causes problems that can be quite serious for some parties. One problem relates to the preparation of consolidated financial statements by companies with foreign operations. Consider General Motors Corporation, which has

subsidiaries in more than 50 countries around the world. Each subsidiary incorporated in the country in which it is located is required to prepare financial statements in accordance with local regulations. These regulations usually require companies to keep books in local currency using local accounting principles. Thus, General Motors de Mexico prepares financial statements in Mexican pesos using Mexican accounting rules and General Motors Japan Ltd. prepares financial statements in Japanese yen using Japanese standards. To prepare consolidated financial statements in the United States, in addition to translating the foreign currency financial statements into U.S. dollars, the parent company must also convert the financial statements of its foreign operations into U.S. GAAP. Each foreign operation must either maintain two sets of books
Prepared in accordance with both local and U.S. GAAP or, as is more common, reconciliations from local GAAP to U.S. GAAP must be made at the balance sheet date. In either case, considerable effort and cost are involved; company personnel must develop an expertise in more than one country's accounting standards.

2. **Access to Foreign Capital Markets**

A second problem caused by accounting diversity relates to companies gaining access to foreign capital markets. If a company desires to obtain capital by selling stock or borrowing money in a foreign country, it might be required to present a set of financial statements prepared in accordance with the accounting standards in the country in which the capital is being obtained. To have stock traded in a country, foreign companies must either prepare financial statements using the country's accounting standards or provide a reconciliation of local GAAP net income and stockholders' equity to the country's GAAP. This can be quite costly. In preparing for a New York Stock Exchange (NYSE) listing in 1993, the German automaker Daimler-Benz estimated it spent $60 million to initially prepare U.S. GAAP financial statements; it expected to spend $15 million to $20 million each year thereafter.

3. **Comparability of Financial Statements**

A third problem relates to the lack of comparability of financial statements between companies from different countries. This can significantly affect the analysis of foreign financial statements for making investment and lending decisions. The job of deciding which foreign company to invest in is complicated by the fact that foreign companies use accounting rules different from those used in Nigeria and those rules differ from country to country. It is very difficult if not impossible for a potential investor to directly compare the financial position and performance of an automobile manufacturer in Germany (Volkswagen), Japan (Nissan), and the United States (Ford) because these three countries have different financial accounting and reporting standards. According to Ralph E. Walters, former chairman of the steering committee of the International Accounting Standards Committee, "either international investors have to be extremely knowledgeable about multiple reporting methods or they have to be willing to take greater risk." A lack of comparability of financial statements also can have an adverse effect on corporations when making foreign acquisition decisions. In many cases, the international public accounting firms were called on to convert financial statements to a Western basis before acquisition of a company could be seriously considered.

4. **Lack of High-Quality Accounting Information**

A fourth problem associated with accounting diversity is the lack of high-quality accounting standards in some parts of the world. There is general agreement that the failure of many banks in the 1997 East Asian financial crisis was due to three factors: a highly leveraged corporate sector, the private sector's reliance on foreign currency debt, and a lack of accounting transparency. To be sure, inadequate disclosure did not create the East Asian meltdown, but it did contribute to the depth and breadth of the crisis. As Rahman explains: "It is a known fact that the very threat of disclosure influences behavior and improves management, particularly risk management. It seems that the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practices of the corporations and banks in

the crisis-hit countries." International investors and creditors were unable to adequately assess risk because financial statements did not reflect the extent of risk exposure due to the following disclosure deficiencies.

Next topic:

International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) set common rules so that financial statements can be consistent, transparent, and comparable around the world. IFRS are issued by the International Accounting Standards Board (IASB). They specify how companies must maintain and report their accounts, defining types of transactions, and other events with financial impact. IFRS were established to create a common accounting language so that businesses and their financial statements can be consistent and reliable from company to company and country to country.

Standard IFRS Requirements

IFRS covers a wide range of accounting activities. There are certain aspects of business practice for which IFRS set mandatory rules.

- **Statement of Financial Position:**

  This is also known as a balance sheet. IFRS influences the ways in which the components of a balance sheet are reported.

- **Statement of Comprehensive Income:**

  This can take the form of one statement, or it can be separated into a profit and loss statement and a statement of other income, including property and equipment.

- **Statement of Changes in Equity:**

  Also known as a statement of retained earnings, this documents the company's change in earnings or profit for the given financial period.

- **Statement of Cash Flow**:

This report summarizes the company's financial transactions in the given period, separating cash flow into Operations, Investing, and Financing.

In addition to these basic reports, a company must also give a summary of its accounting policies. The full report is often seen side by side with the previous report, to show the changes in profit and loss. A parent company must create separate account reports for each of its subsidiary companies.

Advantages of IFRS:

For the conversion from IAS to IF AS, the following advantage is advocated:

(a) IFRS helps to raise Capital abroad since both the countries use IFRS for their allocating standards, i.e., the basis is same.

(b) IFRS helps to present its financial statement on the identical basis like its foreign competitors, i.e., comparisons become easy.

(c) Subsidiary of a foreign company must use IFRS if its parent company follows the same.

(d) It helps the foreign investors who are using IFRS.

(e) One accounting language may be applied in case of a foreign company having subsidiary to some other countries.

Disadvantages of IFRS:

The IFRS even is not free from snags. Some of them are:

(a) There are certain use issuers who will resist IFRS as they do not have any market incentive for the preparation of IFRS financial statements.

(b) Adopting IFRS is costly.

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Next topic:

Adoption of IFRS:

It has already been stated that many countries of the world have already accepted IFRS and some are trying to implements the IFRS as early as possible (e.g. all European Union, Hong Kong, Australia Malaysia, Pakistan, Russia, South Africa, Singapore, Turkey etc.).

Many countries require IFRS reporting for all domestic listed companies. The United States of America is also progressing towards IFRS. For this purpose, they are shifting from US GAAP to accept IFRS. General acceptance of IFRS will, no doubt help the investors as well as the other users of financial statements.

It will improve and increase the quality of information and will also reduce the cost of comparing alternative investments. Since the investors will be more interested to provide financing, companies are also expected to take the advantage of adequate financing.

Structures of IFRS:

IFRSs are basically ‘principle-based set of Standards’ which frame results and various specific treatments of financial statement.

It computes:

(a) Framework for the preparation and presentation of Financial Statement 1989

(b) Standing Interpretation Committee (SIC) issued before 2001

(c) International Accounting Standards (IAS) issued before 1001

(d) Interpretations Originate from the International Financial Reporting Interpolations Committee (IFRIC) — issued after 2001

(e) International Financial Reporting Standards (IFRS) —Issued after 2000.

List of IFRS:

The list of FIRS comprises:

IFRS 1: First Time Adoptions of IFRS

IFRS 2: Share-Based Payments

IFRS 3: Business Combination

IFRS 4: Insurance Contracts

IFRS 5: Non-Current Assets held for Sale and Discontinued Operations

IFRS 6: Exploration for and Evaluation of Mineral Resources

IFRS 7: Financial Instruments; Disclosures

IFRS 8: Operating Segments

IFRS 9: Financial Instruments.

The achievements of International Accounting Standards Board (IASB)

I. The recent IFRSs reflect greater use of fair value in measuring transactions and a movement away from the traditional historical-cost basis of measurement. While fair values are somewhat most subjective than a price paid in a past transaction,

current values are usually more relevant for economic decision making than past costs.

Examples of the use of fair values for measuring profits in recent IFRSs include:
a. Financial instruments (required for trading investments and an option to measure all other financial assets and financial liabilities at fair value)

b. Assets held for disposal

c. Impairment recognition (write-down to fair values)

d. Prohibition of pooling of interests (the required purchase method recognizes the fair values of assets and liabilities acquired in a business combination)

e. Exchanges of similar items of property, plant and equipment

f. Changes in fair values of investments in real estate

g. Changes in fair values of agricultural crops, orchards, forests, and livestock prior to, harvesting.

ii. In the past, companies were able to keep certain obligations and expenses off their books because no IAS required the company to recognize those obligations and expenses. Sometimes, investors found out about the obligations only when a problem developed.
Recent accounting standards have moved off-balance-sheet items onto the balance sheet. In particular:
a. Special purpose entities

b. Derivatives

c. Share-based payment.

Iii. Recent IASs have substantially expanded financial statement disclosures, especially about judgments, plans and assumptions:
a. Greater disclosure about accounting policy choices made by the company

b. Judgments made in applying accounting policies

c. Disclosure of key sources of estimation uncertainties in financial statement amounts

d. Risk-management policies

e. Sensitivity analyses.

iv. Historically, many accounting standards allowed companies to choose between two or more acceptable methods of accounting for the same transaction. Little by little, the IASC and the IASB have eliminated these accounting choices, and the LASB's current projects will eliminate many more.

v. Convergence with US GAAP.

IFRS the nature and operations of the IASB

The IASB was previously known as the International Accounting Standards Committee (IASC) until April 2001, when it became the IASB.

1. The IASC was originally set up in 1973 and was the sole body to have both responsibility and authority to issue international accounting standards. In 2001, when the IASB took over responsibility for international financial reporting, it took on all of the IASC's standards (which were all prefixed with 'IAS' – e.g. IAS 2 Inventories, IAS 10 Events after the Reporting Period). The IASB amended many of the standards, but then began to issue its own standards, which were known as International Financial Reporting Standards (IFRS). This is why you see standards prefixed with IAS (IASC standards) and IFRS (IASB standards). The term 'IFRS' has become a somewhat generic term that refers to all the standards (both IAS and IFRS).

2. On December 31, 2001, The International Accounting Standards Foundation (IASF) was incorporated as a tax-exempt organization in the U.S. state of Delaware. On February 6, 2001, the International Financial Reporting Standards Foundation was also incorporated as a tax-exempt organization in Delaware. The IFRS Foundation is an independent, not-for-profit organization. Its primary mission is to develop, in the public interest, a

single set of high-quality, understandable, enforceable and globally accepted International Financial Reporting Standards (IFRS) based upon clearly articulated principles.

3. The IASB forms part the three-tier structure employed by the IFRS Foundation and is responsible for setting the IFRS and related technical activities. The IASB is overseen by the Trustees of the IFRS Foundation, responsible for the organization's governance, the appointment of IASB members and funding. The IFRS Foundation is publicly accountable to a Monitoring Board of capital market authorities.

4. The IASB originally had 13 full-time Board members, each with one vote. They are selected as a group of experts with a mix of experience of standard-setting, preparing and using accounts, and academic work. At their January 2009 meeting the Trustees of the Foundation concluded the first part of the second Constitution Review, announcing the creation of a Monitoring Board and the expansion of the IASB to 16 members and giving more consideration to the geographical composition of the IASB.

IFRS:

Measurements of the statement of financial position include:

The elements directly related to the

Asset: An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

- **Liability**: A liability is a present obligation of the entity arising from the past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits, i.e. assets.
- **Equity**: Nominal equity is the nominal residual interest in the nominal assets of the entity after deducting all its liabilities in nominal value.

- **Revenues**: increases in economic benefit during an accounting period in the form of inflows or enhancements of assets, or decrease of liabilities that result in increases in equity. However, it does not include the contributions made by the equity participants (for example owners, partners or shareholders).

- **Expenses**: decreases in economic benefits during an accounting period in the form of outflows, or depletions of assets or incurrence's of liabilities that result in decreases in equity. However, these don't include the distributions made to the equity participants.

Next topic:

International Accounting Standards Board (IASB)

The IASB is the independent standard-setting body of the IFRS Foundation responsible for the development and publication of IFRSs and for approving Interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The Board is an independent group of experts with an appropriate mix of recent practical experience in setting accounting standards, in preparing, auditing, or using financial reports, and in accounting education. Broad geographical diversity is also required. The IFRS Foundation Constitution outlines the full criteria for the composition of the Board, and the geographical allocation can be seen on the individual profiles. Board members are responsible for the development and publication of IFRS Standards, including the IFRS for SMEs Standard. The Board is also responsible for approving Interpretations of IFRS Standards as developed by the IFRS Interpretations Committee (formerly IFRIC). Members are appointed by the Trustees of the IFRS Foundation through an open and rigorous process that includes advertising vacancies and consulting relevant organizations.

The IASB originally had 13 full-time Board members, each with one vote. They are selected as a group of experts with a mix of experience of standard-setting, preparing and using accounts, and academic work. At their January 2009 meeting, the Trustees of the Foundation concluded the first part of the second Constitution Review, announcing the creation of a Monitoring Board and the expansion of the IASB to 16 members and giving more consideration to the geographical composition of the IASB. The IFRS Interpretations Committee has 15 members. Its brief is to provide timely guidance on issues that arise in practice. A unanimous vote is not necessary in order for the publication of a Standard, exposure draft, or final "IFRIC" Interpretation. The Board's 2008 Due Process manual stated that approval by nine of the members is required.

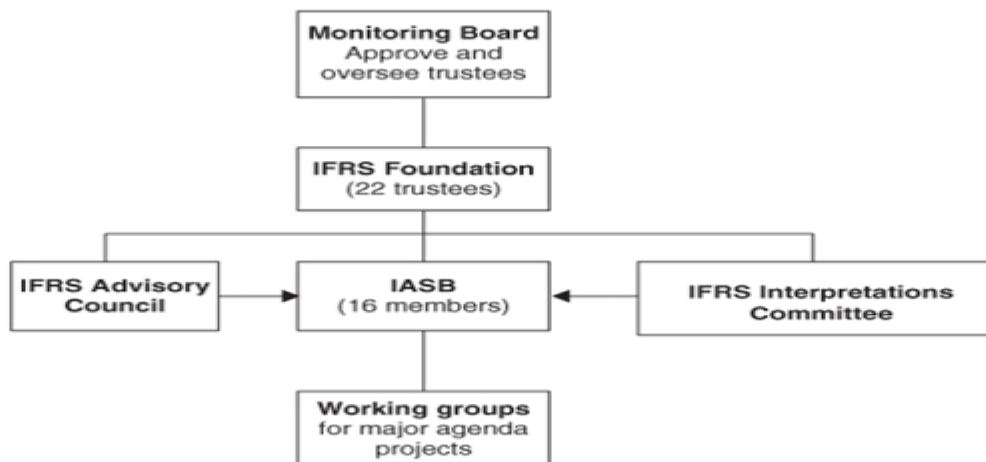
IASB's Role

Under the IFRS Foundation Constitution, the IASB has complete responsibility for all technical matters of the IFRS Foundation including:

- full discretion in developing and pursuing its technical agenda, subject to certain consultation requirements with the Trustees and the public
- the preparation and issuing of IFRSs (other than Interpretations) and exposure drafts, following the due process stipulated in the Constitution
- The approval and issuing of Interpretations developed by the IFRS Interpretations Committee.

IASB - Background and Structure

The IASB was previously known as the International Accounting Standards Committee (IASC) until April 2001, when it became the IASB. The IASC was originally set up in 1973 and was the sole body to have both responsibility and authority to issue international accounting standards. In 2001, when the IASB took over responsibility for international financial reporting, it took on all of the IASC's standards (which were all prefixed with 'IAS' – e.g. IAS 2 Inventories, IAS 10 Events After the Reporting Period). The IASB amended many of the standards, but then began to issue its own standards, which were known as International Financial Reporting Standards (IFRS). This is why you see standards prefixed with IAS (IASC standards) and IFRS (IASB standards). The term 'IFRS' has become a somewhat generic term that refers to all the standards (both IAS and IFRS). The setup of the IASB is as follows:



Next topic:

Standard Setting Process

According to IASB a thorough, transparent and participatory due process is followed when issuing an IFRS Standard or an IFRIC Interpretation that helps companies better implement their Standards. Standard-setting entails:

- Public Board meetings broadcast live from their London office;
- Agenda papers that inform the Board's deliberations;
- Discussion and decision summaries that are made available after meetings; and
- Comment letters received on their consultation documents.

IASB Conceptual Framework

While the International Accounting Standards Board (IASB) is not a country it does have a sort of constitution, in the form of the Conceptual Framework for Financial Reporting (the Framework), that proves the definitive reference document for the development of accounting standards. The Framework can also be described as a theoretical base, a statement of principles, a philosophy and a map. By setting out the very basic theory of accounting the Framework points the way for the development of new accounting standards. It should be noted that the Framework is not an accounting standard, and where there is perceived to be a conflict between the Framework and the specific provisions of an accounting standard then the accounting standard prevails. The IASB Framework:

- seeks to ensure that accounting standards have a consistent approach to problem solving and do not represent a series of ad hoc responses that address accounting problems on a piece meal basis
- assists the IASB in the development of coherent and consistent accounting standards
- is not a standard, but rather acts as a guide to the preparer of financial statements to enable them to resolve accounting issues that are not addressed directly in a standard
- is an important and influential document that helps users understand the purpose of, and limitations of, financial reporting
- used to be called the Framework for the Preparation and Presentation of Financial Statements
- is a current issue as it is being revised as a joint project with the IASB's American counterparts the Financial Accounting Standards Board.

The framework includes the following five elements:

- **Asset:** An asset is defined as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. Assets are presented on the statement of financial position as being non-current or current. They can be intangible, that is, without physical presence – for example, goodwill. Examples of assets include property plant and equipment, financial assets and inventory. While most assets will be both controlled and legally owned by the entity it should be noted that legal ownership is not a prerequisite for recognition, rather it is control that is the key issue.

- **Liability**: A liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities are also presented on the statement of financial position as being non-current or current. Examples of liabilities include trade payables, tax creditors and loans. It should be noted that in order to recognize a liability there does not have to be an obligation that is due on demand but rather there has to be a present obligation.

- **Equity**: Equity is defined as the residual interest in the assets of the entity after deducting all its liabilities. The effect of this definition is to acknowledge the supreme conceptual importance of identifying, recognizing and measuring assets and liabilities, as equity is conceptually regarded as a function of assets and liabilities, ie a balancing figure. Equity includes the original capital introduced by the owners, ie share capital and share premium, the accumulated retained profits of the entity, ie retained earnings, unrealized asset gains in the form of revaluation reserves and, in group accounts, the equity interest in the subsidiaries not enjoyed by the parent company, ie the non-controlling interest (NCI). Slightly more exotically, equity can also include the equity element of convertible loan stock; equity settled share based payments, differences arising when there are increases or decreases in the NCI, group foreign exchange differences and contingently issuable shares. These would probably all be included in equity under the umbrella term of Other Components of Equity.

- **Income**: Income is defined as the increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. Most income is revenue

generated from the normal activities of the business in selling goods and services, and as such is recognized in the Income section of the statement of profit or loss and other comprehensive income, however certain types of income are required by specific standards to be recognized directly to equity, ie reserves, for example certain revaluation gains on assets. In these circumstances the income (gain) is then also reported in the Other Comprehensive Income section of the statement of profit or loss and other comprehensive income. The reference to 'other than those relating to contributions from equity participants' means that when the entity issues shares to equity shareholders, while this clearly increases the asset of cash, it is a transaction with equity participants and so does not represent income for the entity. The definition of income is also linked into assets and liabilities. This is often referred to as 'the balance sheet approach' (the former name for the statement of financial position).

- **Expense:**

Expenses are defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence's of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. Examples of expenses include depreciation, impairment of assets and purchases. As with income most expenses are recognized in the Income Statement section of the statement of profit or loss and other comprehensive income, but in certain circumstances expenses (losses) are required by specific standards to be recognized directly in equity and reported in the Other Comprehensive Income Section of the statement of profit or loss and other comprehensive income. An example of this is an impairment loss, on a previously revalued asset, that does not exceed the balance of its Revaluation Reserve.

Benefits of IFRS Standards

Modern economies rely on cross-border transactions and the free flow of international capital. More than a third of all financial transactions occur across borders, and that number is expected to grow. Investors seek diversification and investment opportunities across the world, while companies raise capital, undertake transactions or have international operations and subsidiaries in multiple countries. In the past, such cross-border activities were complicated by different countries maintaining their own sets of national accounting standards. This patchwork of accounting requirements often added cost, complexity and ultimately risk both to companies preparing financial statements and investors and others using those financial statements to make economic decisions. Applying national

accounting standards meant amounts reported in financial statements might be calculated on a different basis. Unpicking this complexity involved studying the minutiae of national accounting standards, because even a small difference in requirements could have a major impact on a company's reported financial performance and financial position—for example, a company may recognize profits under one set of national accounting standards and losses under another. IFRS Standards address this challenge by providing a high quality, internationally recognized set of accounting standards that bring transparency, accountability and efficiency to financial markets around the world.

- IFRS Standards bring transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.
- IFRS Standards strengthen accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Our Standards provide information that is needed to hold management to account. As a source of globally comparable information, IFRS Standards are also of vital importance to regulators around the world.
- IFRS Standards contribute to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language lowers the cost of capital and reduces international reporting costs.

History of the IASB Conceptual Framework

April 1989	*Framework for the Preparation and Presentation of Financial Statements* (the Framework) was approved by the IASC Board
July 1989	Framework was published
April 2001	Framework adopted by the IASB.
September 2010	*Conceptual Framework for Financial Reporting 2010* (the IFRS Framework) approved by the IASB
March 2018	*Conceptual Framework for Financial Reporting 2018* published

Unit 2

Transfer pricing

Transfer pricing refers to the **pricing strategy** in play when there is transfer of goods/ services between associated enterprises. Transfer pricing law aims to ensure that transactions between associated enterprises[1] does not happen at an unreasonably favorable and controlled price.

Objective of transfer pricing law:

The main objective of **transfer pricing law** in **international transactions** is to ensure that transactions between associated enterprises take place at a price as if the transaction was taking place between unrelated parties.

International Transactions between two associated enterprises[2]:

An 'international transaction' in the context of transfer pricing law shall include a transaction between two or more **associated enterprises**, either or both of whom are non-residents wherein there is purchase, sale or lease of tangible or intangible property, or there is provision of services, or there is lending or borrowing of money.

It becomes important to note here that a transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be an international transaction entered into between two associated enterprises, if:

i. there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or
ii. the terms of the relevant transaction are determined in substance between such other person and the associated enterprise where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not.

Objectives of Transfer Pricing:

The objectives of transfer pricing are as follows:

1) Maximizing overall after-tax profits.

2) Reducing incident of customs duty payments

3) Circumventing the quota restrictions (in value terms) on imports.

4) Reducing exchange exposure, circumventing exchange controls and restricting profit repatriation so that transfer firms affiliates to the parent can be maximized.

5) Transferring of funds in locations so as to suit corporate working capital policies.

6) 'Window dressing' operations to improve the apparent (i.e., reported) financial position of an affiliate so as to enhance its credit ratings.

The objective of transfer price apparently seems simple allocation of profits among the subsidiaries and the parent company, but the differences in the taxation patterns in various markets makes it a complex phenomenon. Transfer prices come under the scrutiny of taxation authorities when it is different from the aim's length price to unrelated parties.

Types of Transfer Pricing Methods used in International Marketing

Some important types of transfer pricing methods used in International Marketing are as follows:

Transfer pricing is the pricing of goods and services exchanged in intra corporate purchase transactions.

1) Transfer at Cost:

Companies using the transfer-at-cost approach recognize that sales by international affiliates contribute to corporate profitability by generating scale economies in domestic manufacturing operations. This approach assumes lower costs lead to better affiliate performance, which ultimately benefits the entire organisation.

The transfer-at-cost method helps keep duties at a minimum. Companies using this approach have no profit expectation on transfer sales; rather, the expectation is that the affiliate will generate the profit by subsequent resale.

2) Cost-Plus Pricing:

Companies that follow the cost-plus pricing method are taking the position that profit must be shown for any product or service at every stage of movement through the corporate system. While cost-plus pricing may result in a price that is completely unrelated to competitive or demand conditions in international markets, many exporters use this approach successfully.

3) Market-Based Transfer Price:

A market-based transfer price is derived from the price required to be competitive in the international market. The constraint on this price is cost. However, there is a considerable degree of variation in how costs are defined. Since costs generally decline with volume, a decision must be made regarding whether to price on the basis of current or planned volume levels. To use market-based transfer prices to enter a new market that is too small to support local manufacturing, third-country sourcing may be required. This enables a company to establish its name or franchise in the market without investing in bricks and mortar.

4) "Arm's-Length" Transfer Pricing:

The price that would have been reached by unrelated parties in a similar transaction is referred to as "arm's-length" transfer pricing. This approach requires identifying an arm's-length price, which may be difficult to do except in the case of commodity-type products. The arm's-length price can be a useful target if it is viewed not as a single point but rather as a range of prices. The important thing to remember is that pricing at arm's length in differentiated products results not in pre- determinable specific prices but in prices that fall within a pre- determinable range.

5) Tax Regulations and Transfer Prices:

Since the global corporation conducts business in a world characterized by different corporate tax rates, there is an incentive to maximize system income in countries with the lowest tax rates and to minimize income in high-tax countries. Governments, naturally, are well aware of this. In recent years, many governments have tried to maximize national tax revenues by examining company returns and mandating reallocation of income and expenses.

Next topic:

Overview

IFRS 10 replaces the part of IAS 27 Consolidated and Separate Financial Statements that addresses accounting for subsidiaries on consolidation. What remains in IAS 27 after the implementation of IFRS 10 is the accounting treatment for subsidiaries, jointly controlled entities and associates in their separate financial statements.

The aim of IFRS 10 is to establish a single control model that is applied to all entities including special purpose entities. The changes require those dealing with the implementation of IFRS 10 to exercise significant judgment to determine

which entities are deemed to be controlled and, therefore require consolidation by the parent company.

Objective of the standard

The objective of IFRS 10 as set out in the standard is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

To meet this objective, the standard:

Requires an entity (the parent) that controls one or more other entities (subsidiaries) to present

• Consolidated financial statements; defines the principle of "control", and establishes control as the basis for consolidation;

• Sets out how to apply the principle of control to identify whether an investor controls an investee and

• Therefore must consolidate the investee; Sets out the accounting requirements for the preparation of consolidated financial statements; and

• Defines an investment entity and sets out the exception to consolidating particular subsidiaries of an

• Investment entity.

Scope of the standard IFRS 10

Applies to all entities, except as follows:

If all the following conditions are met, a parent need not present consolidated financial statements:

• - It is a subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about (and do not object to), the parent not presenting consolidated financial statements;

- Its debt or equity instruments are not traded in a public market;

- It did not file, nor is in the process of filing, financial statements for the purpose of issuing instruments in a public market; and

- Its ultimate or any intermediate parent produces consolidated financial statements that comply with the IFRSs and are available for public use.

- Post or long-term employee benefits plans to which IAS 19 Employee Benefits applies.
- An investment entity need not present consolidated financial statements but rather measure all of its
- Subsidiaries at fair value through profit or loss.

IFRS 10 - effective date

IFRS 10 shall be applied for annual periods beginning on or after 1 January 2013. An entity shall apply those amendments made to IFRS 10 with regards to Investment Entities for annual periods beginning on or after 1 January 2014. Early application is permitted.

Steps to consider when determining whether there is control

The following steps highlight the thought process that should be followed when determining whether the investor's rights' gives it control over the investee.

- Identifying the investee, consideration of its purpose and design
- Identifying the relevant activities of the investee
- Identifying how decisions about the relevant activities are made
- Assessing whether the investor controls the investee

1. **Identifying the investee and considering its purpose and design**

The term "investee" is not defined in IFRS 10, therefore the purpose and design of an investee shall be considered by the investor when assessing whether it has control of an investee.

Investee controlled by means of equity instruments –

An investor controls an investee when the investor holds majority of the voting rights and is able to exercise these rights to determine the investee's operating and financing policies and no additional arrangements that alter this decision making are present.

Where voting rights are not the dominant factor in determining control, the investor would need to consider

The design of the investee in terms of:

- The risks the investee will be exposed to;
- The risk it will pass on to the parties involved with it; and
- Whether the investor is exposed to some or all of that risk

By implication if the investee's risk exposure is high, it passes part of it on to the investor and the investor is exposed to some of that risk, it is likely that the investee has been set up under the power of the investor.

2. **Identifying the relevant activities of the investee**

Relevant activities' is an important new concept, as it assists in determining whether an investor has power over an investee. 'Relevant activities' are defined as 'activities of the investee that SIGNIFICANTLY affect the investee's returns'.

3. **How decisions about the relevant activities are made**

The definition of "power" requires consideration whether the investor has the current ability to direct the relevant activities; therefore it's important that we consider how decisions about the relevant activities are made.

Examples of how decisions about relevant activities are made (not only limited to these);

- Establishing operating and capital decisions of the investee, including budgets; and
- Appointing and remunerating an investee's key management personnel or service providers and

• Terminating their services or employment.

4. **Power over the investee**

Power arises either individually or in combination, from rights: In the form of voting rights or potential voting rights;

• To appoint, reassign, or remove members of an investee's key management personnel or any other entity

• That has the ability to direct the relevant activities; To direct the investee to enter into or veto any changes to transactions for the benefit of the investor; and

• That gives the holder the current ability to direct the relevant activities even if its rights to direct have yet to be exercised.

Accounting requirements

Consolidation procedures	• Combine assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiary • Offset (eliminate) the parent's investment in each subsidiary with its portion of equity of the subsidiary • Eliminate in full all intra-group transactions and balances
Uniform accounting policies	Parent and its subsidiaries must have and apply uniform accounting policies. If not, appropriate adjustments are made when preparing the consolidated financial statements to ensure conformity.
Measurement	Consolidation of a subsidiary begins from the date the investor gains control of an investee and ceases when the investor loses control of an investee
Potential voting rights	Consolidated financial statements are prepared solely on the basis of existing ownership interests. The consolidated financial statements do not reflect the possible exercise or conversion of potential voting rights and other derivatives unless, in substance, an interest is as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest.
Reporting date	Parent and its subsidiaries must have the same reporting date. If not, the subsidiary, for consolidation purposes prepares additional financial information as of the same date as the financial statements of the parent unless it is impracticable to do so. The difference between the reporting dates shall be no more than 3 months.

Disclosure and accounting treatment of non-controlling interests

A parent must present non-controlling interests in the consolidated statement of financial position within equity, separately from the equity of the owners of the

parent. Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions.

Accounting treatment - loss of control

If the parent loses control of a subsidiary, the parent shall:

- Derecognize the assets and liabilities of the former subsidiary.
- Recognize any investment retained in the former subsidiary at its fair value when control is lost and
- Subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRSs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9 or, when appropriate, the cost on initial recognition of an investment in associate or joint venture.
- Recognize the gain or loss associated with the loss of control in profit or loss

Investment entities An investment entity is an entity that:

- Obtains funds from one or more investors for the purpose of providing those investor(s) with investment
- Management services; Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital
- Appreciation, investment income, or both; and Measures and evaluates the performance of substantially all of its investments on a fair value basis.

Typical characteristics of an investment entity:

- It has more than one investment;
- It has more than one investor;
- The investors are not related parties of the entity; and
- It has ownership interests in the form of equity or similar interests.

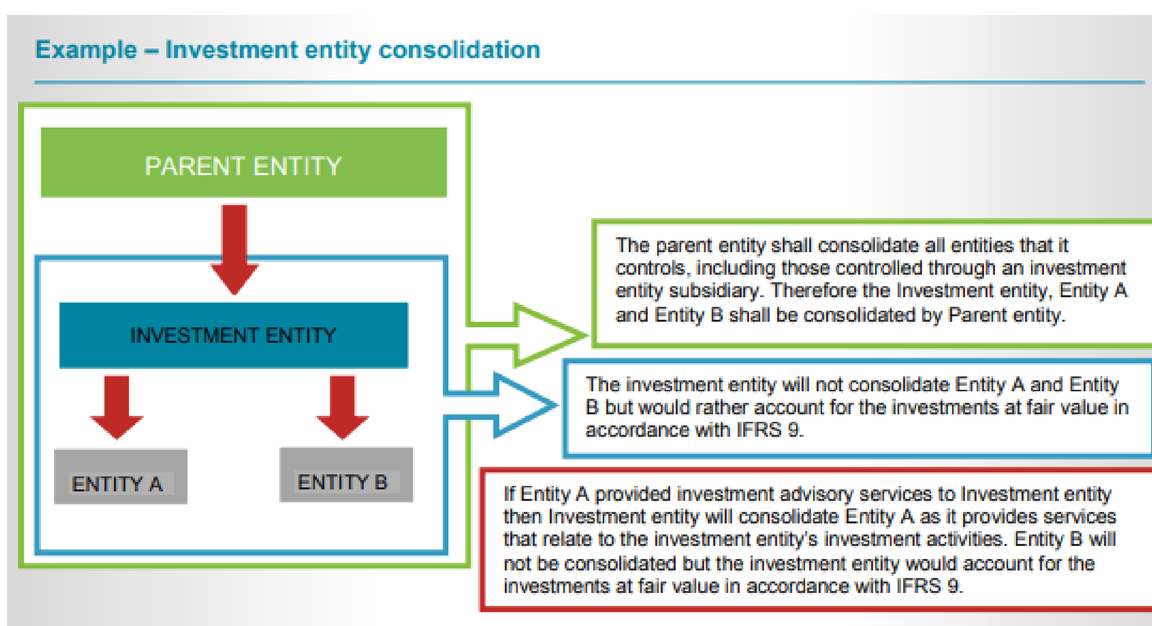
Consolidation specifics and exceptions Investment entities shall not consolidate its subsidiaries but rather measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9

UNLESS:

• If an investment entity has a subsidiary that provides services that relate to the investment entity's investment activities, it shall consolidate that subsidiary.

• A parent of an investment entity shall consolidate all its

Subsidiaries, including the investment entity and any entities controlled through that investment entity, unless the parent itself is an investment entity.



In conclusion

IFRS 10 does not change the consolidation procedures but does change whether an entity is consolidated, by redefining the definition of control.

Next topic: IAS 27

Overview

IAS 27 Separate Financial Statements (as amended in 2011) outlines the accounting and disclosure requirements for 'separate financial statements', which are financial statements prepared by a parent, or an investor in a joint venture or associate, where those investments are accounted for either at cost or in accordance with IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments. The standard also outlines the accounting requirements for dividends and contains numerous disclosure requirements.

IAS 27 was reissued in May 2011 and applies to annual periods beginning on or after 1 January 2013, superseding IAS 27 Consolidated and Separate Financial Statements from that date.

Objectives of IAS 27

IAS 27 has the objective of setting standards to be applied in accounting for investments in subsidiaries, jointly ventures, and associates when an entity elects, or is required by local regulations, to present separate (non-consolidated) financial statements.

Key definitions

Consolidated financial statements

Financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity

Separate financial statements

Financial statements presented by a parent (i.e. an investor with control of a subsidiary), an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 Financial Instruments

Requirement for separate financial statements

IAS 27 does not mandate which entities produce separate financial statements available for public use. It applies when an entity prepares separate financial statements that comply with International Financial Reporting Standards.

Financial statements in which the equity method is applied are not separate financial statements. Similarly, the financial statements of an entity that does not have a subsidiary, associate or joint venture's interest in a joint venture are not separate financial statements.

An investment entity that is required, throughout the current period and all comparative periods presented, to apply the exception to consolidation for all of its subsidiaries in accordance with of IFRS 10 Consolidated Financial Statements presents separate financial statements as its only financial statements.

Choice of accounting method

When an entity prepares separate financial statements, investments in subsidiaries, associates, and jointly controlled entities are accounted for either:

- at cost,
- Or in accordance with IFRS 9 Financial Instruments),
- or using the equity method as described in IAS 28 Investments in Associates and Joint Ventures

The entity applies the same accounting for each category of investments. Investments that are accounted for at cost and classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations are accounted for in accordance with that IFRS. Investments carried at cost should be measured at the lower of their carrying amount and fair value less costs to sell. The measurement of investments accounted for in accordance with IFRS 9 is not changed in such circumstances.

If an entity elects, in accordance with IAS 28 to measure its investments in associates or joint ventures at fair value through profit or loss in accordance with IFRS 9, it shall also account for those investments in the same way in its separate financial statements.

Investment entities

If a parent investment entity is required, in accordance with IFRS 10, to measure its investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9 or IAS 39, it is required to also account for its investment in a subsidiary in the same way in its separate financial statements.

When a parent ceases to be an investment entity, the entity can account for an investment in a subsidiary at cost (based on fair value at the date of change or status) or in accordance with IFRS 9. When an entity becomes an investment entity, it accounts for an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9.

Recognition of dividends

An entity recognizes a dividend from a subsidiary, joint venture or associate in profit or loss in its separate financial statements when its right to receive the dividend in established.

Group reorganizations

Specified accounting applies in separate financial statements when a parent reorganizes the structure of its group by establishing a new entity as its parent in a manner satisfying the following criteria:

- the new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent
- the assets and liabilities of the new group and the original group are the same immediately before and after the reorganization, and
- The owners of the original parent before the reorganization have the same absolute and relative interests in the net assets of the original group and the new group immediately before and after the reorganization.

Where these criteria are met, and the new parent accounts for its investment in the original parent at cost, the new parent measures the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganization.

The above requirements:

- Apply to the establishment of an intermediate parent within a group, as well as establishment of a new ultimate parent of a group.
- Apply to an entity that is not a parent entity and establishes a parent in a manner that satisfies the above criteria.
- Apply only where the criteria above are satisfied and do not apply to other types of reorganizations or for common control transactions more broadly.

Disclosure

When a parent, in accordance with paragraph 4(a) of IFRS 10, elects not to prepare consolidated financial statements and instead prepares separate financial statements, it shall disclose in those separate financial statements

- the fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and principal place of business (and country of incorporation if different) of the entity whose consolidated financial statements that comply with IFRS have been produced for public use; and the address where those consolidated financial statements are obtainable,
- a list of significant investments in subsidiaries, jointly controlled entities, and associates, including the name, principal place of business (and country of incorporation if different), proportion of ownership interest and, if different, proportion of voting rights, and
- a description of the method used to account for the foregoing investments.

When an investment entity that is a parent prepares separate financial statements as its only financial statements, it shall disclose that fact. The investment entity shall also present the disclosures relating to investment entities required by IFRS 12.

When a parent (other than a parent covered by the above circumstances) or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, the parent or investor shall identify the financial statements prepared in accordance with IFRS 10, IFRS 11 or IAS 28 (as amended in 2011) to which they relate. The parent or investor shall also disclose in its separate financial statements

- the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law,
- a list of significant investments in subsidiaries, jointly controlled entities, and associates, including the name, principal place of business (and country of incorporation if different), proportion of ownership interest and, if different, proportion of voting rights, and
- a description of the method used to account for the foregoing investments.

Next topic: IAS 27

Overview

Objectives of IAS 27

IAS 27 has the twin objectives of setting standards to be applied:

- In the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent; and
- In accounting for investments in subsidiaries, jointly controlled entities, and associates when an entity elects, or is required by local regulations, to present separate (non-consolidated) financial statements.

Key definitions

Consolidated financial statements: the financial statements of a group presented as those of a single economic entity.

Subsidiary: an entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

Parent: an entity that has one or more subsidiaries.

Control: the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Identification of subsidiaries

Control is presumed when the parent acquires more than half of the voting rights of the entity. Even when more than one half of the voting rights are not acquired, control may be evidenced by power.

- over more than one half of the voting rights by virtue of an agreement with other investors, or
- to govern the financial and operating policies of the entity under a statute or an agreement; or
- to appoint or remove the majority of the members of the board of directors; or
- To cast the majority of votes at a meeting of the board of directors.

Presentation of consolidated financial statements

A parent is required to present consolidated financial statements in which it consolidates its investments in subsidiaries– with the following exception:

A parent is not required to (but may) present consolidated financial statements if and only if all of the following four conditions are met:

1. the parent is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
2. the parent's debt or equity instruments are not traded in a public market;
3. the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and
4. the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

The consolidated accounts should include all of the parent's subsidiaries, both domestic and foreign:

- There is no exemption for a subsidiary whose business is of a different nature from the parent's.
- There is no exemption for a subsidiary that operates under severe long-term restrictions impairing the subsidiary's ability to transfer funds to the parent. Such an exemption was included in earlier versions of IAS 27, but in revising IAS 27 in December 2003 the IASB concluded that these restrictions, in themselves, do not preclude control.
- There is no exemption for a subsidiary that had previously been consolidated and that is now being held for sale. However, a subsidiary that meets the IFRS 5 criteria as an asset held for sale shall be accounted for under that Standard.

Consolidation procedures

Intragroup balances, transactions, income, and expenses should be eliminated in full. Intragroup losses may indicate that an impairment loss on the related asset should be recognized.

The financial statements of the parent and its subsidiaries used in preparing the consolidated financial statements should all be prepared as of the same reporting date, unless it is impracticable to do so. If it is impracticable a particular subsidiary to prepare its financial statements as of the same date as its parent, adjustments must be made for the effects of significant transactions or events that occur between the dates of the subsidiary's and the parent's financial statements. And in no case may the difference be more than three months.

Consolidated financial statements must be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

Minority interests should be presented in the consolidated balance sheet within equity, but separate from the parent's shareholders' equity. Minority interests in the profit or loss of the group should also be separately disclosed.

Where losses applicable to the minority exceed the minority interest in the equity of the relevant subsidiary, the excess, and any further losses attributable to the minority, are charged to the group unless the minority has a binding obligation to, and is able to, make good the losses. Where excess losses have been taken up by the group, if the subsidiary in question subsequently reports profits, all such profits are attributed to the group until the minority's share of losses previously absorbed by the group has been recovered.

Partial disposal of an investment in a subsidiary

The accounting depends on whether control is retained or lost:

1. **Partial disposal of an investment in a subsidiary while control is retained.**

This is accounted for as an equity transaction with owners, and gain or loss is not recognized.

2. **Partial disposal of an investment in a subsidiary that results in loss of control.**

   Loss of control triggers remeasurement of the residual holding to fair value. Any difference between fair value and carrying amount is a gain or loss on the disposal, recognized in profit or loss. Thereafter, apply IAS 28, IAS 31, or IAS 39, as appropriate, to the remaining holding.

Acquiring additional shares in the subsidiary after control is obtained

Acquiring additional shares in the subsidiary after control was obtained is accounted for as an equity transaction with owners (like acquisition of 'treasury shares'). Goodwill is not premeasured.

Separate financial statements of the parent or investor in an associate or jointly controlled entity

In the parent's/investor's individual financial statements, investments in subsidiaries, associates, and jointly controlled entities should be accounted for either:

- at cost, or
- In accordance with IAS 39.

The parent/investor shall apply the same accounting for each category of investments. Investments that are classified as held for sale in accordance with IFRS 5 shall be accounted for in accordance with that IFRS. Investments carried at cost should be measured at the lower of their carrying amount and fair value less costs to sell. The measurement of investments accounted for in accordance with IAS 39 is not changed in such circumstances. An entity shall recognize a dividend from a subsidiary, jointly controlled entity or associate in profit or loss in its separate financial statements when its right to receive the dividend is established.

Disclosure

Disclosures required in consolidated financial statements:

1. the nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power,
2. the reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control,
3. the reporting date of the financial statements of a subsidiary when such financial statements are used to prepare consolidated financial statements and are as of a reporting date or for a period that is different from that of the parent, and the reason for using a different reporting date or period, and
4. The nature and extent of any significant restrictions on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances.

Disclosures required in separate financial statements that are prepared for a parent that is permitted not to prepare consolidated financial statements:

1. the fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and country of incorporation or residence of the entity whose consolidated financial statements that comply with IFRS have been produced for public use; and the address where those consolidated financial statements are obtainable,
2. a list of significant investments in subsidiaries, jointly controlled entities, and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held, and
3. a description of the method used to account for the foregoing investments.

Disclosures required in the separate financial statements of a parent, investor in a jointly controlled entity, or investor in an associate:

1. the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law,
2. a list of significant investments in subsidiaries, jointly controlled entities, and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held, and
3. a description of the method used to account for the foregoing investments.

Next topic: IFRS 3

BUSINESS COMBINATION:

Overview

IFRS 3 Business Combinations outlines the accounting when an acquirer obtains control of a business (e.g. an acquisition or merger). Such business combinations are accounted for using the 'acquisition method', which generally requires assets acquired and liabilities assumed to be measured at their fair values at the acquisition date.

A revised version of IFRS 3 was issued in January 2008 and applies to business combinations occurring in an entity's first annual period beginning on or after 1 July 2009.

Background

IFRS 3 (2008) seeks to enhance the relevance, reliability and comparability of information provided about business combinations (e.g. acquisitions and mergers) and their effects. It sets out the principles on the recognition and measurement of acquired assets and liabilities, the determination of goodwill and the necessary disclosures.

Key definitions

Business combinations:

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations as that term is used in [IFRS 3]

Business:

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

Acquisition date

The date on which the acquirer obtains control of the acquire

Acquirer

The entity that obtains control of the acquire

Acquiree

The business or businesses that the acquirer obtains control of in a business combination

Scope

IFRS 3 must be applied when accounting for business combinations, but does not apply to:

- The formation of a joint venture
- The acquisition of an asset or group of assets that is not a business, although general guidance is provided on how such transactions should be accounted for
- Combinations of entities or businesses under common control (the IASB has a separate agenda project on common control transactions)
- Acquisitions by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss under IFRS 10 Consolidated Financial Statements.

Determining whether a transaction is a business combination

IFRS 3 provides additional guidance on determining whether a transaction meets the definition of a business combination, and so accounted for in accordance with its requirements. This guidance includes:

1. Business combinations can occur in various ways, such as by transferring cash, incurring liabilities, issuing equity instruments (or any combination thereof), or by not issuing consideration at all (i.e. by contract alone)
2. Business combinations can be structured in various ways to satisfy legal, taxation or other objectives, including one entity becoming a subsidiary of another, the transfer of net assets from one entity to another or to a new entity
3. The business combination must involve the acquisition of a business, which generally has three elements:

Inputs – an economic resource (e.g. non-current assets, intellectual property) that creates outputs when one or more processes are applied to it

Process – a system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs (e.g. strategic management, operational processes, resource management)

Output – the result of inputs and processes applied to those inputs.

Method of accounting for business combinations

Acquisition method

The acquisition method (called the 'purchase method' in the 2004 version of IFRS 3) is used for all business combinations

Steps in applying the acquisition method are:

- Identification of the 'acquirer
- ' Determination of the 'acquisition date'
- Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest (NCI, formerly called minority interest) in the acquiree
- Recognition and measurement of goodwill or a gain from a bargain purchase

Identifying an acquirer

The guidance in IFRS 10 Consolidated Financial Statements is used to identify an acquirer in a business combination, i.e. the entity that obtains 'control' of the acquiree.

If the guidance in IFRS 10 does not clearly indicate which of the combining entities an acquirer is, IFRS 3 provides additional guidance which is then considered:

1. The acquirer is usually the entity that transfers cash or other assets where the business combination is effected in this manner
2. The acquirer is usually, but not always, the entity issuing equity interests where the transaction is effected in this manner, however the entity also considers other pertinent facts and circumstances including:

    - Relative voting rights in the combined entity after the business combination
    - the existence of any large minority interest if no other owner or group of owners has a significant voting interest
    - the composition of the governing body and senior management of the combined entity
    - the terms on which equity interests are exchanged

3. The acquirer is usually the entity with the largest relative size (assets, revenues or profit)

4. For business combinations involving multiple entities, consideration is given to the entity initiating the combination, and the relative sizes of the combining entities.

Acquisition date

An acquirer considers all pertinent facts and circumstances when determining the acquisition date, i.e. the date on which it obtains control of the acquiree. The acquisition date may be a date that is earlier or later than the closing date.

Acquired assets and liabilities

IFRS 3 establishes the following principles in relation to the recognition and measurement of items arising in a business combination:

- Recognition principle. Identifiable assets acquired, liabilities assumed, and non-controlling interests in the acquiree, are recognised separately from goodwill
- Measurement principle. All assets acquired and liabilities assumed in a business combination are measured at acquisition-date fair value.

In applying the principles, an acquirer classifies and designates assets acquired and liabilities assumed on the basis of the contractual terms, economic conditions, operating and accounting policies and other pertinent conditions existing at the acquisition date. For example, this might include the identification of derivative financial instruments as hedging instruments, or the separation of embedded derivatives from host contracts. However, exceptions are made for lease classification (between operating and finance leases) and the classification of contracts as insurance contracts, which are classified on the basis of conditions in place at the inception of the contract.

Acquired intangible assets must be recognized and measured at fair value in accordance with the principles if it is separable or arises from other contractual rights, irrespective of whether the acquiree had recognised the asset prior to the business combination occurring. This is because there is always sufficient information to reliably measure the fair value of these assets. There is no 'reliable measurement' exception for such assets, as was present under IFRS 3 (2004).

Goodwill

Goodwill is measured as the difference between:

The aggregate of

(i) the value of the consideration transferred (generally at fair value), (ii) the amount of any non-controlling interest (NCI, see below), and (iii) in a business combination achieved in stages (see below), the acquisition-date fair value of the acquirer's previously-held equity interest in the acquiree, and

(ii) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed (measured in accordance with IFRS 3). [IFRS 3.32]

This can be written in simplified equation form as follows:

Goodwill = Consideration transferred + Amount of non-controlling interests + Fair value of previous equity interests - Net assets recognised

If the difference above is negative, the resulting gain is a bargain purchase in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion. [IFRS 3.34-35] However, before any bargain purchase gain is recognised in profit or loss, the acquirer is required to undertake a review to ensure the identification of assets and liabilities is complete, and that measurements appropriately reflect consideration of all available information.

Choice in the measurement of non-controlling interests (NCI)

IFRS 3 allows an accounting policy choice, available on a transaction by transaction basis, to measure non-controlling interests (NCI) either at:

- fair value (sometimes called the full goodwill method), or
- the NCI's proportionate share of net assets of the acquiree.

The choice in accounting policy applies only to present ownership interests in the acquiree that entitle holders to a proportionate share of the entity's net assets in the event of a liquidation (e.g. outside holdings of an acquiree's ordinary shares). Other components of non-controlling interests at must be measured at acquisition date

fair values or in accordance with other applicable IFRSs (e.g. share-based payment transactions accounted for under IFRS 2 Share-based Payment).

Business combination achieved in stages (step acquisitions)

Prior to control being obtained, an acquirer accounts for its investment in the equity interests of an acquiree in accordance with the nature of the investment by applying the relevant standard, e.g. IAS 28 Investments in Associates and Joint Ventures (2011), IFRS 11 Joint Arrangements, IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments. As part of accounting for the business combination, the acquirer remeasures any previously held interest at fair value and takes this amount into account in the determination of goodwill as noted above resultant gain or loss is recognised in profit or loss or other comprehensive income as appropriate.

Measurement period

If the initial accounting for a business combination can be determined only provisionally by the end of the first reporting period, the business combination is accounted for using provisional amounts. Adjustments to provisional amounts, and the recognition of newly identified asset and liabilities, must be made within the 'measurement period' where they reflect new information obtained about facts and circumstances that were in existence at the acquisition date. [IFRS 3.45] The measurement period cannot exceed one year from the acquisition date and no adjustments are permitted after one year except to correct an error in accordance with IAS 8.

Related transactions and subsequent accounting

General principles

In general:

- transactions that are not part of what the acquirer and acquiree (or its former owners) exchanged in the business combination are identified and accounted for separately from business combination
- the recognition and measurement of assets and liabilities arising in a business combination after the initial accounting for the business combination is dealt with under other relevant standards, e.g. acquired inventory is subsequently accounted under IAS 2 Inventories.

When determining whether a particular item is part of the exchange for the acquiree or whether it is separate from the business combination, an acquirer considers the reason for the transaction, who initiated the transaction and the timing of the transaction.

Contingent consideration

Contingent consideration must be measured at fair value at the time of the business combination and is taken into account in the determination of goodwill. If the amount of contingent consideration changes as a result of a post-acquisition event (such as meeting an earnings target), accounting for the change in consideration depends on whether the additional consideration is classified as an equity instrument or an asset or liability:

- If the contingent consideration is classified as an equity instrument, the original amount is not remeasured
- If the additional consideration is classified as an asset or liability that is a financial instrument, the contingent consideration is measured at fair value and gains and losses are recognised in either profit or loss or other comprehensive income in accordance with IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement
- If the additional consideration is not within the scope of IFRS 9 (or IAS 39), it is accounted for in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets or other IFRSs as appropriate.

Where a change in the fair value of contingent consideration is the result of additional information about facts and circumstances that existed at the acquisition date, these changes are accounted for as measurement period adjustments if they arise during the measurement period.

Acquisition costs

Costs of issuing debt or equity instruments are accounted for under IAS 32 Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement/IFRS 9 Financial Instruments. All other costs associated with an acquisition must be expensed, including reimbursements to the acquiree for bearing some of the acquisition costs. Examples of costs to be expensed include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; and general administrative costs, including the costs of maintaining an internal acquisitions department.

Pre-existing relationships and reacquired rights

If the acquirer and acquiree were parties to a pre-existing relationship (for instance, the acquirer had granted the acquiree a right to use its intellectual property), this must must be accounted for separately from the business combination. In most cases, this will lead to the recognition of a gain or loss for the amount of the consideration transferred to the vendor which effectively represents a 'settlement' of the pre-existing relationship. The amount of the gain or loss is measured as follows:

- for pre-existing non-contractual relationships (for example, a lawsuit): by reference to fair value
- for pre-existing contractual relationships: at the lesser of (a) the favourable/unfavourable contract position and (b) any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.

However, where the transaction effectively represents a reacquired right, an intangible asset is recognised and measured on the basis of the remaining contractual term of the related contract excluding any renewals. The asset is then subsequently amortised over the remaining contractual term, again excluding any renewals.

Contingent liabilities

Until a contingent liability is settled, cancelled or expired, a contingent liability that was recognised in the initial accounting for a business combination is measured at the higher of the amount the liability would be recognised under IAS 37 Provisions, Contingent Liabilities and Contingent Assets, and the amount less accumulated amortisation under IAS 18 Revenue.

Contingent payments to employees and shareholders

As part of a business combination, an acquirer may enter into arrangements with selling shareholders or employees. In determining whether such arrangements are part of the business combination or accounted for separately, the acquirer considers a number of factors, including whether the arrangement requires continuing employment (and if so, its term), the level or remuneration compared to other employees, whether payments to shareholder employees are incremental to non-

employee shareholders, the relative number of shares owns, linkages to valuation of the acquiree, how the consideration is calculated, and other agreements and issues.

Where share-based payment arrangements of the acquiree exist and are replaced, the value of such awards must be apportioned between pre-combination and post-combination service and accounted for accordingly.

Indemnification assets

Indemnification assets recognised at the acquisition date (under the exceptions to the general recognition and measurement principles noted above) are subsequently measured on the same basis of the indemnified liability or asset, subject to contractual impacts and collectibility. Indemnification assets are only derecognised when collected, sold or when rights to it are lost.

Other issues

In addition, IFRS 3 provides guidance on some specific aspects of business combinations including:

- business combinations achieved without the transfer of consideration, e.g. 'dual listed' and 'stapled' arrangements
- reverse acquisitions
- identifying intangible assets acquired

Disclosure

Disclosure of information about current business combinations

An acquirer is required to disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the end of the period but before the financial statements are authorised for issue.

Among the disclosures required to meet the foregoing objective are the following:

- name and a description of the acquiree
- acquisition date
- percentage of voting equity interests acquired

- primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree
- description of the factors that make up the goodwill recognised
- qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations, intangible assets that do not qualify for separate recognition
- acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration
- details of contingent consideration arrangements and indemnification assets
- details of acquired receivables
- the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed
- details of contingent liabilities recognised
- total amount of goodwill that is expected to be deductible for tax purposes
- details about any transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination
- information about a bargain purchase
- information about the measurement of non-controlling interests
- details about a business combination achieved in stages
- information about the acquiree's revenue and profit or loss
- information about a business combination whose acquisition date is after the end of the reporting period but before the financial statements are authorised for issue

Disclosure of information about adjustments of past business combinations

An acquirer is required to disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.

Among the disclosures required to meet the foregoing objective are the following:

- details when the initial accounting for a business combination is incomplete for particular assets, liabilities, non-controlling interests or items of consideration (and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally)
- follow-up information on contingent consideration

- follow-up information about contingent liabilities recognised in a business combination
- a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period, with various details shown separately
- the amount and an explanation of any gain or loss recognized in the current reporting period that both:

  1. relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period, and
  2. Is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements.

Next topic: IAS 28

Overview

IAS 28 Investments in Associates and Joint Ventures (as amended in 2011) outlines how to apply, with certain limited exceptions, the equity method to investments in associates and joint ventures. The standard also defines an associate by reference to the concept of "significant influence", which requires power to participate in financial and operating policy decisions of an investee (but not joint control or control of those polices).

IAS 28 was reissued in May 2011 and applies to annual periods beginning on or after 1 January 2013

Objective of IAS 28

The objective of IAS 28 (as amended in 2011) is to prescribe the accounting for investments in associates and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

Scope of IAS 28

IAS 28 applies to all entities that are investors with joint control of, or significant influence over, an investee (associate or joint venture).

Key definitions

- **Associate**

An entity over which the investor has significant influence

- **Significant influence**

The power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies

- **Joint arrangement**

An arrangement of which two or more parties have joint control

- **Joint control**

The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control

- **Joint venture**

A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement

- **Joint venturer**

A party to a joint venture that has joint control of that joint venture

- **Equity method**

A method of accounting whereby the investment is initially recognized at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Significant influence

Where an entity holds 20% or more of the voting power (directly or through subsidiaries) on an investee, it will be presumed the investor has significant influence unless it can be clearly demonstrated that this is not the case. If the holding is less than 20%, the entity will be presumed not to have significant influence unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

1. representation on the board of directors or equivalent governing body of the investee;
2. participation in the policy-making process, including participation in decisions about dividends or other distributions;
3. material transactions between the entity and the investee;
4. interchange of managerial personnel;
5. or provision of essential technical information

The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances that affect potential rights.

An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels.

The equity method of accounting

1. Basic principle

Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.

2. Distributions and other adjustments to carrying amount.

The investor's share of the investee's profit or loss is recognized in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income (e.g. to account for changes arising from revaluations of property, plant and equipment and foreign currency translations.

3. Potential voting rights

An entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and, generally, does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments.

4. Interaction with IFRS 9

IFRS 9 Financial Instruments does not apply to interests in associates and joint ventures that are accounted for using the equity method. An entity applies IFRS 9, including its impairment requirements, to long-term interests in an associate or joint venture that form part of the net investment in the associate or joint venture but to which the equity method is not applied. Instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with IFRS 9, unless they currently give access to the returns associated with an ownership interest in an associate or a joint venture.

5. Classification as non-current asset

An investment in an associate or a joint venture is generally classified as non-current asset, unless it is classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

Application of the equity method of accounting

Basic principle

In its consolidated financial statements, an investor uses the equity method of accounting for investments in associates and joint ventures. Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. Furthermore, the concepts

underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

Exemptions from applying the equity method

An entity is exempt from applying the equity method if the investment meets one of the following conditions:

The entity is a parent that is exempt from preparing consolidated financial statements under IFRS 10 Consolidated Financial Statements or if all of the following four conditions are met (in which case the entity need not apply the equity method):

- the entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to,
- the investor not applying the equity method the investor or joint venture's debt or equity instruments are not traded in a public market
- the entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market, and
- the ultimate or any intermediate parent of the parent produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.

Classification as held for sale

When the investment, or portion of an investment, meets the criteria to be classified as held for sale, the portion so classified is accounted for in accordance with IFRS 5. Any remaining portion is accounted for using the equity method until the time of disposal, at which time the retained investment is accounted under IFRS 9, unless the retained interest continues to be an associate or joint venture.

Discontinuing the equity method

Use of the equity method should cease from the date that significant influence or joint control ceases:

- If the investment becomes a subsidiary, the entity accounts for its investment in accordance with IFRS 3 Business Combinations and IFRS 10
- If the retained interest is a financial asset, it is measured at fair value and subsequently accounted for under IFRS 9
- Any amounts recognized in other comprehensive income in relation to the investment in the associate or joint venture are accounted for on the same basis as if the investee had directly disposed of the related assets or liabilities (which may require reclassification to profit or loss)
- If an investment in an associate becomes an investment in a joint venture (or vice versa), the entity continues to apply the equity method and does not premeasured the retained interest.

Changes in ownership interests

If an entity's interest in an associate or joint venture is reduced, but the equity method is continued to be applied, the entity reclassifies to profit or loss the proportion of the gain or loss previously recognized in other comprehensive income relative to that reduction in ownership interest.

Equity method procedures

1. **Transactions with associates or joint ventures.**

   Profits and losses resulting from upstream (associate to investor, or joint venture to joint venturer) and downstream (investor to associate, or joint venturer to joint venture) transactions are eliminated to the extent of the investor's interest in the associate or joint venture. However, unrealised losses are not eliminated to the extent that the transaction provides evidence of a reduction in the net realisable value or in the recoverable amount of the assets transferred. Contributions of non-monetary assets to an associate or joint venture in exchange for an equity interest in the associate or joint venture are also accounted for in accordance with these requirements.

2. **Initial accounting**

   An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities in case of goodwill is included in the carrying amount of the investment (amortization

not permitted) and any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired. Adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date or for impairment losses such as for goodwill or property, plant and equipment.

3. **Date of financial statements**

In applying the equity method, the investor or joint venturer should use the financial statements of the associate or joint venture as of the same date as the financial statements of the investor or joint venturer unless it is impracticable to do so. If it is impracticable, the most recent available financial statements of the associate or joint venture should be used, with adjustments made for the effects of any significant transactions or events occurring between the accounting period ends. However, the difference between the reporting date of the associate and that of the investor cannot be longer than three months.

4. **Accounting policies**

If the associate or joint venture uses accounting policies that differ from those of the investor, the associate or joint venture's financial statements are adjusted to reflect the investor's accounting policies for the purpose of applying the equity method.

5. **Application of the equity method by a non-investment entity investor to an investment entity investee**

When applying the equity method to an associate or a joint venture, a non-investment entity investor in an investment entity may retain the fair value measurement applied by the associate or joint venture to its interests in subsidiaries. The election is made separately for each associate or joint venture.

6. **Losses in excess of investment**

If an investor's or joint venture's share of losses of an associate or joint venture equals or exceeds its interest in the associate or joint venture, the investor or joint

venturer discontinues recognising its share of further losses. The interest in an associate or joint venture is the carrying amount of the investment in the associate or joint venture under the equity method together with any long-term interests that, in substance, form part of the investor or joint venturer's net investment in the associate or joint venture. After the investor or joint venturer's interest is reduced to zero, a liability is recognised only to the extent that the investor or joint venturer has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate or joint venture subsequently reports profits, the investor or joint venturer resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognized.

Impairment

After application of the equity method an entity applies IAS 39 Financial Instruments: Recognition and Measurement to determine whether it is necessary to recognise any additional impairment loss with respect to its net investment in the associate or joint venture. If impairment is indicated, the amount is calculated by reference to IAS 36 Impairment of Assets. The entire carrying amount of the investment is tested for impairment as a single asset, that is, goodwill is not tested separately. The recoverable amount of an investment in an associate is assessed for each individual associate or joint venture, unless the associate or joint venture does not generate cash flows independently.

Separate financial statements

An investment in an associate or a joint venture shall be accounted for in the entity's separate financial statements in accordance with IAS 27 Separate Financial Statements.

Disclosure

There are no disclosures specified in IAS 28. Instead, IFRS 12 Disclosure of Interests in Other Entities outlines the disclosures required for entities with joint control of, or significant influence over, an investee.

Unit 3

IFRS 11

Overview

IFRS 11 Joint Arrangements outlines the accounting by entities that jointly control an arrangement. Joint control involves the contractually agreed sharing of control and arrangements subject to joint control are classified as either a joint venture (representing a share of net assets and equity accounted) or a joint operation (representing rights to assets and obligations for liabilities, accounted for accordingly).

IFRS 11 was issued in May 2011 and applies to annual reporting periods beginning on or after 1 January 2013.

Core principle

The core principle of IFRS 11 is that a party to a joint arrangement determines the type of joint arrangement in which it is involved by assessing its rights and obligations and accounts for those rights and obligations in accordance with that type of joint arrangement.

Key definitions

- **Joint arrangement**

An arrangement of which two or more parties have joint control

- **Joint control**

The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control

- **Joint operation**

A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement

- **Joint venture**

A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement

- **Joint venturer**

A party to a joint venture that has joint control of that joint venture

- **Party to a joint arrangement**

An entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement

- **Separate vehicle**

A separately identifiable financial structure, including separate legal entities or entities recognized by statute, regardless of whether those entities have a legal personality

Joint arrangements

A joint arrangement is an arrangement of which two or more parties have joint control.

A joint arrangement has the following characteristics:

1. the parties are bound by a contractual arrangement, and
2. The contractual arrangement gives two or more of those parties joint control of the arrangement.

A joint arrangement is either a joint operation or a joint venture.

Joint control

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Before assessing whether an entity has joint control over an arrangement, an entity first assesses whether the parties, or a group of the parties, control the arrangement (in accordance with the definition of control in IFRS 10 Consolidated Financial Statements).

After concluding that all the parties, or a group of the parties, controls the arrangement collectively, an entity shall assess whether it has joint control of the arrangement. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that collectively control the arrangement.

The requirement for unanimous consent means that any party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions (about the relevant activities) without its consent.

Types of joint arrangements

Joint arrangements are either joint operations or joint ventures:

1. A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.
2. A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint ventures.

Classifying joint arrangements

The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement. An entity determines the type of joint arrangement in which it is involved by considering the structure and form of the arrangement, the terms agreed by the parties in the contractual arrangement and other facts and circumstances.

Regardless of the purpose, structure or form of the arrangement, the classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement.

A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle can be either a joint venture or a joint operation.

A joint arrangement that is not structured through a separate vehicle is a joint operation. In such cases, the contractual arrangement establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement, and the

parties' rights to the corresponding revenues and obligations for the corresponding expenses.

Financial statements of parties to a joint arrangement

Joint operations

A joint operator recognizes in relation to its interest in a joint operation:

- its assets, including its share of any assets held jointly;
- its liabilities, including its share of any liabilities incurred jointly;
- its revenue from the sale of its share of the output of the joint operation;
- its share of the revenue from the sale of the output by the joint operation; and
- Its expenses, including its share of any expenses incurred jointly.

A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant IFRSs.

The acquirer of an interest in a joint operation, in which the activity constitutes a business, as defined in IFRS 3 Business Combinations, is required to apply all of the principles on business combinations accounting in IFRS 3 and other IFRSs with the exception of those principles that conflict with the guidance in IFRS 11. These requirements apply both to the initial acquisition of an interest in a joint operation, and the acquisition of an additional interest in a joint operation (in the latter case, previously held interests are not premeasured).

A party that participates in, but does not have joint control of, a joint operation shall also account for its interest in the arrangement in accordance with the above if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation.

Joint ventures

A joint venturer recognizes its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with IAS 28 Investments in Associates and Joint Ventures unless the entity is exempted from applying the equity method as specified in that standard.

A party that participates in, but does not have joint control of, a joint venture accounts for its interest in the arrangement in accordance with IFRS 9 Financial Instruments unless it has significant influence over the joint venture, in which case it accounts for it in accordance with IAS 28 (as amended in 2011).

Separate Financial Statements

The accounting for joint arrangements in an entity's separate financial statements depends on the involvement of the entity in that joint arrangement and the type of the joint arrangement:

1. If the entity is a joint operator or joint venturer it shall account for its interest in

- a joint operation in accordance with paragraphs 20-22;
- a joint venture in accordance with paragraph 10 of IAS 27 Separate Financial Statements

2. If the entity is a party that participates in, but does not have joint control of, a joint arrangement shall account for its interest in:

- a joint operation in accordance with paragraphs 23;
- a joint venture in accordance with IFRS 9, unless the entity has significant influence over the joint venture, in which case it shall apply paragraph 10 of IAS 27 (as amended in 2011).

Disclosure

There are no disclosures specified in IFRS 11. Instead, IFRS 12 Disclosure of Interests in Other Entities outlines the disclosures required.

Next topic:

IFRS 12

Overview

IFRS 12 Disclosure of Interests in Other Entities is a consolidated disclosure standard requiring a wide range of disclosures about an entity's interests in

subsidiaries, joint arrangements, associates and unconsolidated 'structured entities'. Disclosures are presented as a series of objectives, with detailed guidance on satisfying those objectives.

IFRS 12 was issued in May 2011 and applies to annual periods beginning on or after 1 January 2013.

Objective and scope

The objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate:

- The nature of, and risks associated with, its interests in other entities
- The effects of those interests on its financial position, financial performance and cash flows.

Where the disclosures required by IFRS 12, together with the disclosures required by other IFRSs, do not meet the above objective, an entity is required to disclose whatever additional information is necessary to meet the objective.

IFRS 12 is required to be applied by an entity that has an interest in any of the following:

- subsidiaries
- joint arrangements (joint operations or joint ventures)
- Associates
- unconsolidated structured entities

IFRS 12 does not apply to certain employee benefit plans, separate financial statements to which IAS 27 Separate Financial Statements applies (except in relation to unconsolidated structured entities and investment entities in some cases), certain interests in joint ventures held by an entity that does not share in joint control, and the majority of interests in another entity accounted for in accordance with IFRS 9 Financial Instruments.

An investment entity that prepares financial statements in which all of its subsidiaries are measured at fair value through profit or loss presents the disclosures relating to investment entities required by IFRS 12

Key definition

- **Interest in other entity:**

  Refers to contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity. An interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees. It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship.

- **Structured entity**

  An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

Disclosures required

Significant judgments and assumptions

- An entity discloses information about significant judgments and assumptions it has made (and changes in those judgments and assumptions) in determining
- that it controls another entity that it has joint control of an arrangement or significant influence over another entity the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle

Interests in subsidiaries

An entity shall disclose information that enables users of its consolidated financial statements to:

- understand the composition of the group
- understand the interest that non-controlling interests have in the group's activities and cash flows

- evaluate the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group
- evaluate the nature of, and changes in, the risks associated with its interests in consolidated structured entities
- evaluate the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control
- Evaluate the consequences of losing control of a subsidiary during the reporting period.

Interests in unconsolidated subsidiaries

In accordance with IFRS 10 Consolidated Financial Statements, an investment entity is required to apply the exception to consolidation and instead account for its investment in a subsidiary at fair value through profit or loss.

Where an entity is an investment entity, IFRS 12 requires additional disclosure, including:

- the fact the entity is an investment entity
- information about significant judgments and assumptions it has made in determining that it is an investment entity, and specifically where the entity does not have one or more of the 'typical characteristics' of an investment entity
- details of subsidiaries that have not been consolidated (name, place of business, ownership interests held)
- details of the relationship and certain transactions between the investment entity and the subsidiary (e.g. restrictions on transfer of funds, commitments, support arrangements, contractual arrangements
- information where an entity becomes, or ceases to be, an investment entity

An entity making these disclosures are not required to provide various other disclosures required by IFRS 12.

Interests in joint arrangements and associates

An entity shall disclose information that enables users of its financial statements to evaluate:

- the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship

with the other investors with joint control of, or significant influence over, joint arrangements and associates
- The nature of, and changes in, the risks associated with its interests in joint ventures and associates.

Interests in unconsolidated structured entities

An entity shall disclose information that enables users of its financial statements to:

- Understand the nature and extent of its interests in unconsolidated structured entities
- Evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

- # Next topic:

IAS 21

Overview

IAS 21 The Effects of Changes in Foreign Exchange Rates outlines how to account for foreign currency transactions and operations in financial statements, and also how to translate financial statements into a presentation currency. An entity is required to determine a functional currency (for each of its operations if necessary) based on the primary economic environment in which it operates and generally records foreign currency transactions using the spot conversion rate to that functional currency on the date of the transaction.

IAS 21 was reissued in December 2003 and applies to annual periods beginning on or after 1 January 2005.

Objective of IAS 21

The objective of IAS 21 is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency. The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

Key definitions

Functional currency:

The currency of the primary economic environment in which the entity operates. (The term 'functional currency' was used in the 2003 revision of IAS 21 in place of 'measurement currency' but with essentially the same meaning.)

Presentation currency:

The currency in which financial statements are presented.

Exchange difference:

the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Foreign operation:

a subsidiary, associate, joint venture, or branch whose activities are based in a country or currency other than that of the reporting entity.

Basic steps for translating foreign currency amounts into the functional currency

Steps apply to a stand-alone entity, an entity with foreign operations (such as a parent with foreign subsidiaries), or a foreign operation (such as a foreign subsidiary or branch).

1. the reporting entity determines its functional currency

2. the entity translates all foreign currency items into its functional currency

Foreign currency transactions

A foreign currency transaction should be recorded initially at the rate of exchange at the date of the transaction (use of averages is permitted if they are a reasonable approximation of actual).

At each subsequent balance sheet dates:

- foreign currency monetary amounts should be reported using the closing rate
- Non-monetary items carried at historical cost should be reported using the exchange rate at the date of the transaction
- Non-monetary items carried at fair value should be reported at the rate that existed when the fair values were determined

Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognised or in previous financial statements are reported in profit or loss in the period, with one exception. The exception is that exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised, in the consolidated financial statements that include the foreign operation, in other comprehensive income; they will be recognised in profit or loss on disposal of the net investment.

As regards a monetary item that forms part of an entity's investment in a foreign operation, the accounting treatment in consolidated financial statements should not be dependent on the currency of the monetary item. Also, the accounting should not depend on which entity within the group conducts a transaction with the foreign operation.If a gain or loss on a non-monetary item is recognised in other comprehensive income (for example, a property revaluation under IAS 16), any foreign exchange component of that gain or loss is also recognised in other comprehensive income.

Translation from the functional currency to the presentation currency

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency using the following procedures:

- Assets and liabilities for each balance sheet presented (including comparatives) are translated at the closing rate at the date of that balance sheet. This would include any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation are treated as part of the assets and liabilities of the foreign operation
- Income and expenses for each income statement (including comparatives) are translated at exchange rates at the dates of the transactions; and all

resulting exchange differences are recognized in other comprehensive income.

Special rules apply for translating the results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy into a different presentation currency.

Where the foreign entity reports in the currency of a hyperinflationary economy, the financial statements of the foreign entity should be restated as required by IAS 29 Financial Reporting in Hyperinflationary Economies, before translation into the reporting currency.

The requirements of IAS 21 regarding transactions and translation of financial statements should be strictly applied in the changeover of the national currencies of participating Member States of the European Union to the Euro – monetary assets and liabilities should continue to be translated the closing rate, cumulative exchange differences should remain in equity and exchange differences resulting from the translation of liabilities denominated in participating currencies should not be included in the carrying amount of related assets.

Disposal of a foreign operation

When a foreign operation is disposed of, the cumulative amount of the exchange differences recognised in other comprehensive income and accumulated in the separate component of equity relating to that foreign operation shall be recognised in profit or loss when the gain or loss on disposal is recognised.

Disclosure

- The amount of exchange differences recognized in profit or loss (excluding differences arising on financial instruments measured at fair value through profit or loss in accordance with IAS 39
- Net exchange differences recognized in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period
- When the presentation currency is different from the functional currency, disclose that fact together with the functional currency and the reason for using a different presentation currency
- A change in the functional currency of either the reporting entity or a significant foreign operation and the reason there for

When an entity presents its financial statements in a currency that is different from its functional currency, it may describe those financial statements as complying with IFRS only if they comply with all the requirements of each applicable Standard (including IAS 21) and each applicable Interpretation.

Convenience translations

Sometimes, an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency simply by translating all amounts at end-of-period exchange rates. This is sometimes called a convenience translation. A result of making a convenience translation is that the resulting financial information does not comply with all IFRS, particularly IAS 21. In this case, the following disclosures are required:

• clearly identify the information as supplementary information to distinguish it from the information that complies with IFRS
• Disclose the currency in which the supplementary information is displayed

• Disclose the entity's functional currency and the method of translation used to determine the supplementary information

Unit 4

Strategic issue Faced by the Multinational Companies (MNC's)

A multinational company (MNC) is an enterprise that manages production or delivers services in more than one country. There are some challenges faced by MNC's that transact business in international markets which can hinder its competitiveness hence its controversies and these are as follows;

1. **Market Imperfections**

It may seem strange that a corporation has decided to do business in a different country, where it doesn't know the laws, local customs or business practices of such a country is likely to face some challenges that can reduce the manager's ability to forecast business conditions. The additional costs caused by the entrance in foreign markets are of less interest for the local enterprise. Firms can also in their own market be isolated from competition by transportation costs and other tariff and non-tariff barriers which can force them to competition and will reduce their profits. The firms can maximize their joint income by merger or acquisition which will lower the competition in the shared market. This could also be the case if there are few substitutes or limited licenses in a foreign market.

2. **Tax Competition**

Countries and sometimes sub national regions compete against one another for the establishment of MNC facilities, subsequent tax revenue, employment, and economic activity. To compete, countries and regional political districts must offer incentives to MNCs such as tax breaks, pledges of governmental assistance or improved infrastructure. When these incentives fail they are liable to face challenges which limit their chance of becoming more attractive to foreign investment. However, some scholars have argued that multinationals are engaged in a 'race to the top.' While multinationals certainly regard a low tax burden or low labor costs as an element of comparative advantage, there is no evidence to suggest that MNCs deliberately avail themselves of tax environmental regulation or poor labour standards.

3. **Political Instability**

Many multinational enterprises face the challenge of political instability when doing business in international markets. This kind of problem mostly occurs when there is an absence of a reliable government authority. When this happens, it adds to business costs, increase risks of doing business and sometimes reduces manager's ability to forecast business trends. Political instability is also associated with corruption and weak legal frameworks that discourage foreign investments.

4. **Market Withdrawal**

The size of multinationals can have a significant impact on government policy, primarily through the threat of market withdrawal. For example, in an effort to reduce health care costs, some countries have tried to force pharmaceutical companies to license their patented drugs to local competitors for a very low fee, thereby artificially lowering the price. When faced with that threat, multinational pharmaceutical firms have simply withdrawn from the market, which often leads to

limited availability of advanced drugs. Countries that have been the most successful in this type of confrontation with multinational corporations are large countries such as United States and Brazil, which have viable indigenous market competitors.

5. **Lobbying**

Multinational corporate lobbying is directed at a range of business concerns, from tariff structures to environmental regulations. Companies that have invested heavily in pollution control mechanisms may lobby for very tough environmental standards in an effort to force non-compliant competitors into a weaker position. Corporations lobby tariffs to restrict competition of foreign industries. For every tariff category that one multinational wants to have reduced, there is another multinational that wants the tariff raised. Even within the U.S. auto industry, the fraction of a company's imported components will vary, so some firms favor tighter import restrictions, while others favor looser ones. This is very serious and is very hard and takes a lot of work for the owner.

Next topic

Corporate social reporting

A CSR, corporate social responsibility or sustainability report is a periodical (usually annual) report published by companies with the goal of sharing their corporate social responsibility actions and results. The report synthesizes and makes public the information organizations decide to communicate regarding their commitments and actions in social and environmental areas. By doing so, organizations let stakeholders (i.e., all parties interested in their activities) aware of how they are integrating the principles of sustainable development into their everyday operations.

Purpose of a CSR Report

The main intention of a CSR or sustainability report is to improve the transparency of organizations' activities. The goal is twofold:

- On one hand, CSR reports aim to enable companies to measure the impact of their activities on the environment, on society and on the economy (the famous triple-bottom-line). In this way, companies can get accurate and

insightful data which will help them improve their processes and have a more positive impact in society and in the world.

- On the other hand, a CSR or sustainability report also allows companies to externally communicate with their stakeholders what are their goals regarding sustainable development and CSR. This allows stakeholders such as employees, investors, media, NGOs, among other interested parties, to get to know better what are the short, medium and long-term goals of companies and make more informed decisions. These decisions can spread from investing in a business, buying its products, writing positive (or negative) reviews, protesting in the streets against the intentions or actions of an organization.

Definition of a CSR Report

According to the Global Reporting Initiative, a CSR report can be defined as:
"A sustainability report is a report published by a company or organization about the economic, environmental and social impacts caused by its everyday activities. A sustainability report also presents the organization's values and governance model, and demonstrates the link between its strategy and its commitment to a sustainable global economy."

Benefits of Communicating Sustainable Practices

1. **The Internal Organizational Benefits of a Sustainability Report**

Internally speaking, CSR reports are important because they allow companies to estimate the impact their operations have on the environment, society, and the economy. Through the (supposedly) detailed and meaningful data collected (or simply gathered) for the sustainability report, companies have a chance to improve their operations and to reduce operational costs. Not only do they become better prepared to optimize and reduce their energy consumption; as a result of reviewing their waste cycles product innovation strategies or **circular economy** opportunities can be found.
At the same time, collecting this data requires joint efforts from different departments. As a result of the hype that's created, employees often end up becoming more conscious the company is focusing on CSR and sustainability, which leaves them proud – increasing employee retention and decreasing turnover (and its costs). It's good news for **employer branding**.

2. **The External Organizational Benefits of a Sustainability Report**

When it comes to external benefits, a CSR and sustainability report can help companies engage better with their interested parties. By letting their stakeholders know about the organization's short, medium and long-term project decisions, companies can be better understood which may have positive financial outputs. For instance, a sustainability report helps stakeholders become aware of whether a company is positively contributing to minimizing the negative impacts of an environmental hazard or that it is only focused on growing profits for its managers and investors. Silence is also a way of communication and if no sustainability report is found the odds are people will focus on the second option just mentioned. In this way, consumers can decide whether they want to buy from a brand that protects orangutans by sourcing sustainable palm oil or one that produces clothes locally with little environmental harm and paying fair wages. Investors can anticipate if companies are becoming more resilient to face consequences of climate change and decide whether to invest in them or not. Journalists can share best case practices from companies leading the way on topics such as micro plastics pollution or ocean acidification. NGOs can exert pressure and expose irresponsible practices

CSR Reports Mandatory:

It isn't (at least yet) mandatory for all companies to make their own CSR or sustainability reports. Yet, **directive 2014/95** from the European Union demands large companies to reveal certain non-financial information about how they operate and run their social and environmental challenges. This means it is mandatory for large public interest entities to disclose non-financial information.
Specifically, it's mandatory that these organizations give insights about how they're taking care of environmental, social and personnel concerns. Diversity and inclusion, respect for human rights, and the fight against corruption and bribery inside businesses and within value chains are issues that must be contextualized too. Consequently, specific organizational data needs to be provided about the policies being pursued, as well as their outcomes. The main organizational risks identified and how they're being managed, together with the financial indicators used must be presented as well.
This kind of information helps consumers, investors, policymakers and other stakeholders to evaluate the non-financial performance of large companies and encourages organizations to develop **sustainable business strategies** that can be up to the expectations.

Contents Included In a Sustainability Report

There's is no one-size-fits-all approach to designing a sustainability report. While some (medium-large) organizations choose to write a standardized report that becomes along with certification, others opt instead for a free-style sustainability report. Either way, what is often included in a sustainability report is:

1. A CEO statement that briefly introduces the vision and the drivers behind the sustainability report;
2. A presentation of the organization's governance structure and business model;
3. The sustainability context, i.e., kind of a SWOT analysis explaining what's happening at the market and industry levels;
4. Inspired by the SWOT analysis, an impact assessment can be done to identify the organization's main negative impacts and business risks (in which indicators to measure progress are also identified);
5. An identification of the organization's main stakeholders and the issues that worry them the most;
6. A materiality analysis in which the main worries of the organization (4) and stakeholders (5) are identified as the priorities;
7. An overview of performance over time in which progress over time is shared – via key indicators and metrics;
8. Some stories and appealing pictures of how the sustainability strategy is leaving employees more motivated to work, investors more willing to invest or NGOs collaborating in strategic projects.

Examples of Companies with Good CSR Reports

- **Example of Sustainability or CSR Reports: the European Investment Bank**
- **Patagonia**
- **IKEA**
- **Unilever**
- **Bloomberg**
- **Nike**

Next topic

Differences between IFRS and GAAP accounting

International Financial Reporting Standards (IFRS) – as the name implies – is an international standard developed by the International Accounting Standards Board (IASB). U.S. Generally Accepted Accounting Principles (GAAP) is only used in the United States. GAAP is established by the Financial Accounting Standards Board (FASB).

1. **Local vs. Global**

IFRS is used in more than 110 countries around the world, including the EU and many Asian and South American countries. GAAP, on the other hand, is only used in the United States. Companies that operate in the U.S. and overseas may have more complexities in their accounting.

2. **Rules vs. Principles**

GAAP tends to be more rules-based, while IFRS tends to be more principles-based. Under GAAP, companies may have industry-specific rules and guidelines to follow, while IFRS has principles that require judgment and interpretation to determine how they are to be applied in a given situation.

However, convergence projects between FASB and IASB have resulted in new GAAP and IFRS standards that share more similarities than differences. For example, the recent GAAP standard for revenue from contracts with customers, Auditing Standards Update (ASU) No. 2014-09 (Topic 606) and the corresponding IFRS standard, IFRS 15, share a common principles-based approach.

3. **Inventory Methods**

Both GAAP and IFRS allow First In, First Out (FIFO), weighted-average cost, and specific identification methods for valuing inventories. However, GAAP also allows the Last In, First Out (LIFO) method, which is not allowed under IFRS. Using the LIFO method may result in artificially low net income and may not reflect the actual flow of inventory items through a company.

4. **Inventory Write-Down Reversals**

Both methods allow inventories to be written down to market value. However, if the market value later increases, only IFRS allows the earlier write-down to be reversed. Under GAAP, reversal of earlier write-downs is prohibited. Inventory valuation may be more volatile under IFRS.

5. **Fair Value Revaluations**

IFRS allows revaluation of the following assets to fair value if fair value can be measured reliably: inventories, property, plant & equipment, intangible assets, and investments in marketable securities. This revaluation may be either an increase or a decrease to the asset's value. Under GAAP, revaluation is prohibited except for marketable securities.

6. **Impairment Losses**

Both standards allow for the recognition of impairment losses on long-lived assets when the market value of an asset declines. When conditions change, IFRS allows impairment losses to be reversed for all types of assets except goodwill. GAAP takes a more conservative approach and prohibits reversals of impairment losses for all types of assets.

7. **Intangible Assets**

Internal costs to create intangible assets, such as development costs, are capitalized under IFRS when certain criteria are met. These criteria include consideration of the future economic benefits.

Under GAAP, development costs are expensed as incurred, with the exception of internally developed software. For software that will be used externally, costs are capitalized once technological feasibility has been demonstrated. If the software will only be used internally, GAAP requires capitalization only during the development stage. IFRS has no specific guidance for software.

8. **Fixed Assets**

GAAP requires that long-lived assets, such as buildings, furniture and equipment, be valued at historic cost and depreciated appropriately. Under IFRS, these same assets are initially valued at cost, but can later be revalued up or down to market value. Any separate components of an asset with different useful lives are required to be depreciated separately under IFRS. GAAP allows for component depreciation, but it is not required.

9. **Investment Property**

IFRS includes the distinct category of investment property, which is defined as property held for rental income or capital appreciation. Investment property is initially measured at cost, and can be subsequently revalued to market value. GAAP has no such separate category.

10. **Lease Accounting**

While the approaches under GAAP and IFRS share a common framework, there are a few notable differences. IFRS has a de minimum exception, which allows lessees to exclude leases for low-valued assets, while GAAP has no such exception. The IFRS standard includes leases for some kinds of intangible assets, while GAAP categorically excludes leases of all intangible assets from the scope of the lease accounting standard.

Next topic:

IFRS- Roadmap

Phase I-

From 1st April, 2016 **Ind AS** will be mandatory for following companies –

- Companies whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India **and** having net worth of 500 crore INR or more.
- Companies having net worth of 500 crore INR or more other than those covered above.
- Holding, subsidiary, joint venture or associate companies of companies covered above.

Phase II –

Ind AS will be mandatorily applicable to the following companies for periods beginning on or after **1 April 2017**, with comparatives for the period ending **31 March 2017** or thereafter:

- Companies whose equity and/or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than rupees 500 Crore.
- Unlisted companies other than those covered in Phase I and Phase II whose net worth are more than 250 crore INR but less than 500 crore INR.
- Holding, subsidiary, joint venture or associate companies of above companies.

Net worth

- It has been clarified that net worth will be determined based on the standalone accounts of the company as on 31 March 2014 or the first audited period ending after that date.
- Net worth has been defined to have the same meaning as per section 2(57) of the Companies Act, 2013. It is the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

Standalone and consolidated financial statements

- It is now clear that Ind AS will apply to both consolidated and stand-alone financial statements of a company covered by the roadmap. This is helpful as companies will not have to maintain dual accounting systems.

Benefit of IFRS –

- IFRS will benefit the economy by increasing the participation in global business.
- Financial Statements prepared with global common set of accounting standard will help global investors to understand Indian financial statements and evaluate the better opportunities available here.
- Our industry will be able to raise more capital from abroad at lower interest rate if it create confidence in the mind of respective investor that their financial statements comply with globally accepted accounting standards
- Most of European countries have already implements IFRS form 2005 and whole world is expected to adhere with the same norms

Next topic

First time adoption of IFRS

Overview

IFRS 1 First-time Adoption of International Financial Reporting Standards sets out the procedures that an entity must follow when it adopts IFRSs for the first time as the basis for preparing its general purpose financial statements. The IFRS grants

limited exemptions from the general requirement to comply with each IFRS effective at the end of its first IFRS reporting period.

A restructured version of IFRS 1 was issued in November 2008 and applies if an entity's first IFRS financial statements are for a period beginning on or after 1 July 2009.

Objective

IFRS 1 First-time Adoption of International Financial Reporting Standards sets out the procedures that an entity must follow when it adopts IFRSs for the first time as the basis for preparing its general purpose financial statements.

Definition of first-time adoption

A first-time adopter is an entity that, for the first time, makes an explicit and unreserved statement that its general purpose financial statements comply with IFRSs.

An entity may be a first-time adopter if, in the preceding year, it prepared IFRS financial statements for internal management use, as long as those IFRS financial statements were not made available to owners or external parties such as investors or creditors. If a set of IFRS financial statements was, for any reason, made available to owners or external parties in the preceding year, then the entity will already be considered to be on IFRSs, and IFRS 1 does not apply.

An entity can also be a first-time adopter if, in the preceding year, its financial statements:

- asserted compliance with some but not all IFRSs, or
- Included only a reconciliation of selected figures from previous GAAP to IFRSs. (Previous GAAP means the GAAP that an entity followed immediately before adopting to IFRSs.)

However, an entity is not a first-time adopter if, in the preceding year, its financial statements asserted:

- Compliance with IFRSs even if the auditor's report contained a qualification with respect to conformity with IFRSs.
- Compliance with both previous GAAP and IFRSs.

An entity that applied IFRSs in a previous reporting period, but who's most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with IFRSs can choose to:

- apply the requirements of IFRS 1 (including the various permitted exemptions to full retrospective application), or
- Retrospectively apply IFRSs in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, as if it never stopped applying IFRSs.

Overview for an entity that adopts IFRSs for the first time in its annual financial statements for the year ended 31 December 2014

Accounting policies

Select accounting policies based on IFRSs effective at 31 December 2014.

IFRS reporting periods

Prepare at least 2014 and 2013 financial statements and the opening statement of financial position (as of 1 January 2013 or beginning of the first period for which full comparative financial statements are presented, if earlier) by applying the IFRSs effective at 31 December 2014.

Since IAS 1 requires that at least one year of comparative prior period financial information be presented, the opening statement of financial position will be 1 January 2013 if not earlier. This would mean that an entity's first financial statements should include at least:

- Three statements of financial position
- two statements of profit or loss and other comprehensive income
- Two separate statements of profit or loss (if presented)
- two statements of cash flows
- two statements of changes in equity, and
- related notes, including comparative information

If a 31 December 2014 adopter reports selected financial data (but not full financial statements) on an IFRS basis for periods prior to 2013, in addition to full financial statements for 2014 and 2013, that does not change the fact that its opening IFRS statement of financial position is as of 1 January 2013.

Adjustments required moving from previous GAAP to IFRSs at the time of first-time adoption

Derecognition of some previous GAAP assets and liabilities

The entity should eliminate previous-GAAP assets and liabilities from the opening statement of financial position if they do not qualify for recognition under IFRSs. For example:

- IAS 38 does not permit recognition of expenditure on any of the following as an intangible asset:
- Research
- Start-up, pre-operating, and pre-opening costs
- Training
- Advertising and promotion
- Moving and relocation

If the entity's previous GAAP had recognized these as assets, they are eliminated in the opening IFRS statement of financial position

- If the entity's previous GAAP had allowed accrual of liabilities for "general reserves", restructurings, future operating losses, or major overhauls that do not meet the conditions for recognition as a provision under IAS 37, these are eliminated in the opening IFRS statement of financial position

- If the entity's previous GAAP had allowed recognition of contingent assets, these are eliminated in the opening IFRS statement of financial position

Recognition of some assets and liabilities not recognised under previous GAAP

Conversely, the entity should recognize all assets and liabilities that are required to be recognized by IFRS even if they were never recognized under previous GAAP. For example:

- IAS 39 requires recognition of all derivative financial assets and liabilities, including embedded derivatives. These were not recognized under many local GAAPs.
- IAS 19 requires an employer to recognize a liability when an employee has provided service in exchange for benefits to be paid in the future. These are not just post-employment benefits (e.g., pension plans) but also obligations

for medical and life insurance, vacations, termination benefits, and deferred compensation. In the case of 'over-funded' defined benefit plans, this would be a plan asset.

- IAS 37 requires recognition of provisions as liabilities. Examples could include an entity's obligations for restructurings, onerous contracts, decommissioning, remediation, site restoration, warranties, guarantees, and litigation.
- Deferred tax assets and liabilities would be recognized in conformity with IAS 12.

Reclassification

The entity should reclassify previous-GAAP opening statement of financial position items into the appropriate IFRS classification.

Examples:

- IAS 10 does not permit classifying dividends declared or proposed after the statement of financial position date as a liability at the statement of financial position date. If such liability was recognized under previous GAAP it would be reversed in the opening IFRS statement of financial position.
- If the entity's previous GAAP had allowed treasury stock (an entity's own shares that it had purchased) to be reported as an asset, it would be reclassified as a component of equity under IFRS.
- Items classified as identifiable intangible assets in a business combination accounted for under the previous GAAP may be required to be reclassified as goodwill under IFRS 3 because they do not meet the definition of an intangible asset under IAS 38. The converse may also be true in some cases.
- IAS 32 has principles for classifying items as financial liabilities or equity. Thus mandatorily redeemable preferred shares that may have been classified as equity under previous GAAP would be reclassified as liabilities in the opening IFRS statement of financial position.
- The reclassification principle would apply for the purpose of defining reportable segments under IFRS 8.
- Some offsetting (netting) of assets and liabilities or of income and expense items that had been acceptable under previous GAAP may no longer be acceptable under IFRS.

Measurement

The general measurement principle – there are several significant exceptions noted below – is to apply effective IFRSs in measuring all recognised assets and liabilities.

How to recognize adjustments required to move from previous GAAP to IFRSs

Adjustments required to move from previous GAAP to IFRSs at the date of transition should be recognized directly in retained earnings or, if appropriate, another category of equity at the date of transition to IFRSs.

Estimates

In preparing IFRS estimates at the date of transition to IFRSs retrospectively, the entity must use the inputs and assumptions that had been used to determine previous GAAP estimates as of that date (after adjustments to reflect any differences in accounting policies). The entity is not permitted to use information that became available only after the previous GAAP estimates were made except to correct an error.

Changes to disclosures

For many entities, new areas of disclosure will be added that were not requirements under the previous GAAP (perhaps segment information, earnings per share, discontinuing operations, contingencies and fair values of all financial instruments) and disclosures that had been required under previous GAAP will be broadened (perhaps related party disclosures).

Disclosure of selected financial data for periods before the first IFRS statement of financial position

If a first-time adopter wants to disclose selected financial information for periods before the date of the opening IFRS statement of financial position, it is not required to conform that information to IFRS. Conforming that earlier selected financial information to IFRSs is optional.

If the entity elects to present the earlier selected financial information based on its previous GAAP rather than IFRS, it must prominently label that earlier information as not complying with IFRS and, further, it must disclose the nature of the main adjustments that would make that information comply with IFRS. This latter disclosure is narrative and not necessarily quantified.

Disclosures in the financial statements of a first-time adopter

IFRS 1 requires disclosures that explain how the transition from previous GAAP to IFRS affected the entity's reported financial position, financial performance and cash flows. This includes:

1. Reconciliations of equity reported under previous GAAP to equity under IFRS both (a) at the date of transition to IFRSs and (b) the end of the last annual period reported under the previous GAAP. (For an entity adopting IFRSs for the first time in its 31 December 2014 financial statements, the reconciliations would be as of 1 January 2013 and 31 December 2013.)
2. reconciliations of total comprehensive income for the last annual period reported under the previous GAAP to total comprehensive income under IFRSs for the same period
3. explanation of material adjustments that were made, in adopting IFRSs for the first time, to the statement of financial position, statement of comprehensive income and statement of cash flows (the latter if presented under previous GAAP)
4. if errors in previous GAAP financial statements were discovered in the course of transition to IFRSs, those must be separately disclosed
5. if the entity recognized or reversed any impairment losses in preparing its opening IFRS statement of financial position, these must be disclosed
6. appropriate explanations if the entity has elected to apply any of the specific recognition and measurement exemptions permitted under IFRS 1 – for instance, if it used fair values as deemed cost

Disclosures in interim financial reports

If an entity is going to adopt IFRSs for the first time in its annual financial statements for the year ended 31 December 2014, certain disclosure are required in its interim financial statements prior to the 31 December 2014 statements, but only if those interim financial statements purport to comply with IAS 34 Interim Financial Reporting. Explanatory information and a reconciliation are required in the interim report that immediately precedes the first set of IFRS annual financial statements. The information includes reconciliations between IFRS and previous GAAP.

Exceptions to the retrospective application of other IFRSs

Prior to 1 January 2010, there were three exceptions to the general principle of retrospective application. On 23 July 2009, IFRS 1 was amended, effective 1 January 2010, to add two additional exceptions with the goal of further simplifying the transition to IFRSs for first-time adopters.

IAS 39 – Derecognition of financial instruments

A first-time adopter shall apply the derecognition requirements in IAS 39 prospectively for transactions occurring on or after 1 January 2004. However, the entity may apply the derecognition requirements retrospectively provided that the needed information was obtained at the time of initially accounting for those transactions.

IAS 39 – Hedge accounting

The general rule is that the entity shall not reflect in its opening IFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with IAS 39. However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate an individual item within that net position as a hedged item in accordance with IFRS, provided that it does so no later than the date of transition to IFRSs.

IAS 27 – Non-controlling interest

IFRS 1.B7 lists specific requirements of IFRS 10 Consolidated Financial Statements that shall be applied prospectively.

Full-cost oil and gas assets

Entities using the full cost method may elect exemption from retrospective application of IFRSs for oil and gas assets. Entities electing this exemption will use the carrying amount under its old GAAP as the deemed cost of its oil and gas assets at the date of first-time adoption of IFRSs.

Determining whether an arrangement contains a lease

If a first-time adopter with a leasing contract made the same type of determination of whether an arrangement contained a lease in accordance with previous GAAP as that required by IFRIC 4 Determining whether an Arrangement Contains a Lease, but at a date other than that required by IFRIC 4, the amendments exempt the entity from having to apply IFRIC 4 when it adopts IFRSs.

Optional exemptions from the basic measurement principle in IFRS 1

There are some further optional exemptions to the general restatement and measurement principles set out above. The following exceptions are individually optional. They relate to:

- Business combinations
- share-based payment transactions
- insurance contracts
- fair value, previous carrying amount, or revaluation as deemed cost
- Leases
- cumulative translation differences
- investments in subsidiaries, jointly controlled entities, associates and joint ventures
- assets and liabilities of subsidiaries, associated and joint ventures
- compound financial instruments
- designation of previously recognized financial instruments
- fair value measurement of financial assets or financial liabilities at initial recognition
- decommissioning liabilities included in the cost of property, plant and equipment
- financial assets or intangible assets accounted for in accordance with IFRIC 12 Service Concession Arrangements
- borrowing costs
- transfers of assets from customers
- extinguishing financial liabilities with equity instruments
- severe hyperinflation
- joint arrangements
- stripping costs in the production phase of a surface mine

Business combinations that occurred before opening statement of financial position date

IFRS 1 includes Appendix C explaining how a first-time adopter should account for business combinations that occurred prior to transition to IFRS.

An entity may keep the original previous GAAP accounting that is, not restated:

- Previous mergers or goodwill written-off from reserves

- the carrying amounts of assets and liabilities recognized at the date of acquisition or merger, or
- how goodwill was initially determined (do not adjust the purchase price allocation on acquisition)

However, should it wish to do so, an entity can elect to restate all business combinations starting from a date it selects prior to the opening statement of financial position date.

In all cases, the entity must make an initial IAS 36 impairment test of any remaining goodwill in the opening IFRS statement of financial position, after reclassifying, as appropriate, previous GAAP intangibles to goodwill.

The exemption for business combinations also applies to acquisitions of investments in associates, interests in joint ventures and interests in a joint operation when the operation constitutes a business.

Deemed cost

Assets carried at cost (e.g. property, plant and equipment) may be measured at their fair value at the date of transition to IFRSs. Fair value becomes the 'deemed cost' going forward under the IFRS cost model. Deemed cost is an amount used as a surrogate for cost or depreciated cost at a given date.

If, before the date of its first IFRS statement of financial position, the entity had revalued any of these assets under its previous GAAP either to fair value or to a price-index-adjusted cost, that previous GAAP revalued amount at the date of the revaluation can become the deemed cost of the asset under IFRS.

If, before the date of its first IFRS statement of financial position, the entity had made a one-time revaluation of assets or liabilities to fair value because of a privatization or initial public offering, and the revalued amount became deemed cost under the previous GAAP, that amount would continue to be deemed cost after the initial adoption of IFRS.

This option applies to intangible assets only if an active market exists.

If the carrying amount of property, plant and equipment or intangible assets that are used in rate-regulated activities includes amounts under previous GAAP that do not qualify for capitalization in accordance with IFRSs, a first-time adopter may

elect to use the previous GAAP carrying amount of such items as deemed cost on the initial adoption of IFRSs.

IAS 19 – Employee benefits: actuarial gains and losses

An entity may elect to recognize all cumulative actuarial gains and losses for all defined benefit plans at the opening IFRS statement of financial position date (that is, reset any corridor recognized under previous GAAP to zero), even if it elects to use the IAS 19 corridor approach for actuarial gains and losses that arise after first-time adoption of IFRS. If a first-time adopter uses this exemption, it shall apply it to all plans.

IAS 21 – Accumulated translation reserves

An entity may elect to recognize all translation adjustments arising on the translation of the financial statements of foreign entities in accumulated profits or losses at the opening IFRS statement of financial position date (that is, reset the translation reserve included in equity under previous GAAP to zero). If the entity elects this exemption, the gain or loss on subsequent disposal of the foreign entity will be adjusted only by those accumulated translation adjustments arising after the opening IFRS statement of financial position date.

IAS 27 – Investments in separate financial statements

In May 2008, the IASB amended the standard to change the way the cost of an investment in the separate financial statements is measured on first-time adoption of IFRSs. The amendments to IFRS 1:

- allow first-time adopters to use a 'deemed cost' of either fair value or the carrying amount under previous accounting practice to measure the initial cost of investments in subsidiaries, jointly controlled entities and associates in the separate financial statements
- remove the definition of the cost method from IAS 27 and add a requirement to present dividends as income in the separate financial statements of the investor
- require that, when a new parent is formed in a reorganization, the new parent must measure the cost of its investment in the previous parent at the carrying amount of its share of the equity items of the previous parent at the date of the reorganization

Assets and liabilities of subsidiaries, associates and joint ventures: different IFRS adoption dates of investor and investee

If a subsidiary becomes a first-time adopter later than its parent, IFRS 1 permits a choice between two measurement bases in the subsidiary's separate financial statements. In this case, a subsidiary should measure its assets and liabilities as either:

- the carrying amount that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary or
- the carrying amounts required by IFRS 1 based on the subsidiary's date of transition to IFRSs

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

If a parent becomes a first-time adopter later than its subsidiary, the parent should in its consolidated financial statements, measure the assets and liabilities of the subsidiary at the same carrying amount as in the separate financial statements of the subsidiary, after adjusting for consolidation adjustments and for the effects of the business combination in which the parent acquired the subsidiary. The same approach applies in the case of associates and joint ventures.

Next topic:

ETHICAL ISSUES IN ACCOUNTING AND FINANCIAL REPORTING

1. Financial reporting is deceitful:

From the last twenty years the financial scandals is a center of attention on Financial reporting of fraudulent. The management of company is an intentionally misapplication of amount with intent to deceive the investors and showing fake the company's share price. The main area of fraudulent

activities is by showing the fictitious revenue, recognition of premature revenue, adjustments of revenue by misstatement entries. In short period of time, when the company's stock price is high but in long period it badly effect on enterprise then it automatically understand by business concern the financial reporting is misrepresents their accounts.

2. **Assets misappropriation**: In accounting one of important ethical issues is the misappropriation of assets at an individual employee level. It directly and indirectly affects the company's staff morale and reputation. The company's management made an embezzlement of assets by misleading
The accounts and preparing a wrong invoices and documents. Assets Misappropriation by use of company assets other than company interests for any other purpose.

3. Full Disclosure: financial reporting is subtopics of fraudulent, disclosure infringement are errors of ethical mistake resulting from neglect. Sometime information is not disclosed in a prescribed way with GAAP and accounts are Not prepared with honesty then it is to be considered financial reporting is a fraudulent activities. The entire beneficial person who are interested in the business sectors but when they know information of full disclosure is not success to investors. Then business concerns change their decisions for investments in the enterprises should be reckon as financial reporting is fraudulent.

SOLUTION ETHICAL ISSUES RELATING TO FINANCIAL REPORTING AND ACCOUNTING

There are certain rules and regulations for financial reporting and accounting standards at the time of preparing financial statements. It must be followed the GAAP ,securities and exchange commission, investment accounting , disclosure rules and International Financial Reporting Systems guidelines and prepare the financial statement according the new guidelines.

1.Proper evidenced based approach: the supporting document must be proper arranged and make provision for it to be kept up to date.

2. Significance of consistency: uniformity is important issues to the users across the enterprises because financial reports are disclose a true and fair view of financial statement of the enterprises.

3. Involvement in information technology system: optimal use of multiple data systems which useful at the time of financial closing and reporting

activities like workflow of material, updates account chart and participants experiences etcs.

4. Management and internal supports: senior and knowledgeable person of management must be presenting business speech on various matters of accounts, meeting with external stakeholders which are very important for any companies. And sometimes also abode on internal issues of companies like how to deal with factors of risk and assessment of internal structure.

Next topic:

Meaning of Window Dressing:

Window Dressing is a device or a tool in the hands of an accountant who can use it to prepare and present financial statements of an organisation in such a way as desired by its owners. Window dressing is also known as creating accounting because financial statements are created by the accountants on the whims of their masters so as to please them.

Window dressing is a device or a tool to bring glamour into the position, statement.

The creations of secret reserves, under and over valuation of inventories shifting the methods of depreciations, creating provisions on current assets are the ways or methods of window dressing in the hands of accountants. Some of the ways are listed out as under:

Ways of Window Dressing:

(i) Creation of Secret Reserves:

The building up of secret reserve is an important and the most popular way in the hands of accountants the financial statements are prepared and presented in such a

way that they are not able to bring them to an open eye. Creation of secret reserves is fashionable and many a time is applauded.

Secret reserve is also known as unpublished reserve. This unpublished reserve can be created as under:

1. Under statement of assets can be done by charging more than reasonable or allowable depreciation.

2. Creation of more provisions for bad debts or discounts on debtors than expected bad debts or discount on debtors.

3. Over statement of liabilities along with understatement of owner claim.

4. Treatment of contingent liabilities as actual liabilities on the liability side of balance sheet.

(ii) Under and Over Valuation of Inventories:

Inventories are the most important part of current assets of an organisation. Valuation of inventories do effect the estimation of working capital of an organisation. Accountants now a day's do the valuation of their inventories as desired by top officials.

Undervaluation of inventory in hand at the end of the accounting period means lowering down the profits and vice a versa. Sometimes obsolete stocks are shown at some values which actually they do not have, so as to improve current ratio of the concern.

1. Under valuation of opening inventories will show rise in profits.

2. Over valuation of opening inventories will lower down the profits.

3. Under valuation of closing inventories will lower down the profits.

4. Over valuation of closing inventories will show rise in profits.

5. Inclusion of dead or worthless stock will improve current ratio of the concern.

(iii) Methods of Depreciation:

It is in practice to show fixed assets at their acquisition costs irrespective of their market values. Application of the method of depreciation is again in the hands of an accountant. Choice of an appropriate method of depreciation may help the accountant in creative accounting or window dressing.

Shifting of one method to another by creating a need is another device in the hands of an accountant. In a way, financial statement particularly balance sheet presents an artificial view as created by an accountant.

(iv) Creation of Provisions: The convention of conservatism provides a safeguard against the overstatement of profits. This convention says those never anticipate profits but create provision for losses. The purpose of this doctrine is to ensure that an accountant adopts a cautious approach while preparing income statement.

Now a days accountants use this convention as a way to create income statement on the whims of the owners. By creating excess provisions accountants can lower down profits to reduce tax burden and to lower down the rate of dividends and vice-versa.

(v) Abuses of accounting Concepts and Conventions:

Accounting being a language of a business has evolved certain basic principles, conventions and concepts for practising the accountancy. These concepts, and conventions have been developed with the passage of time to help accountants to understand and apply them while preparing and constructing their financial statements.

These conventions are being abused by some of the accountants for creative accounting for instance.

Convention of conservatism is being misused by the accountants for creating secret reserves by the help of following ways:

(i) Excessive provision of bad debts, discounts on debtors

(ii) By charging excess depreciation on fixed assets

(iii) By amortizing excess on intangible assets

(iv) Artificial fall in value of shares caused by suppressed profits

(vi) Unrealistic Assumptions:

Financial statements are prepared or constructed by accountants on basic unrealistic assumption like stable monetary unit who can imagine the validity of stable monetary unit in the periods of violently changing prices. No doubt this assumption is much far from reality.

Creative accountants enjoy such basic unrealistic assumptions for manipulation of accounts. Gradual erosion in the purchasing power of monetary units such as rupee or dollar do effect the preparation of accounts. How these accounts expressed in

monetary unit which is losing its power can reflect a true and fair view of the affairs of an organisation?

(vii) Off balance sheet financing:

When debt financing is not shown on the face of balance sheet that is called off balance sheet financing. This method of Window Dressing is used to mislead the investors. Generally investors use to calculate gearing ratios to assess financial position of a corporate unit.

(viii) Creating Special Purpose Vehicle:

Sometimes a special purpose vehicle is created for a particular financial transaction. That is also by creating special purpose entity.

Means to Check Window Dressing:

1. Verification and Valuation of Assets:

Verification of assets would help to guard against improper increase of values or creation of those assets which actually do not exist. This is primary and important responsibility of management accountants. The modern function of management accountant is not only to verify but to protect the assets also verification further includes valuation of assets.

Generally valuation of assets will involve following points for consideration:

(i) Acquisition cost of asset

(ii) Life of the asset

(iii) Depreciation and method of depreciation to be applied

(iv) Scrap value at the end of the life of asset

(v) Provisions for contingencies

(vi) Basis of Valuation

Management accountant has to keep in mind which basis of the valuation is being followed since asset can be valued at realizable values or replacement cost. He should ensure that the method of valuation conforms to the principles on which assets are being valued.

In examining the intangible assets like goodwill patents, brands etc. some points he has to keep in mind that what was the basis for valuation at the time of their origin, adequacy of the amortization procedure, consistency followed in recording such assets. Nowadays intangible assets like brands are gaining importance and are subject to correct or realistic valuation. Management accountants are to ensure their accurate valuation as some of them may be un-saleable.

2. Verification and Valuation of Inventories:

Verification and valuation of inventories is another mean available to check window dressing. Inclusion of obsolete stock or dead stock may cheat the user of the financial statements. Valuation of stocks may be done on the FIFO system or LIFO system, market price or average price. Choice of the method may lead to understatement or overstatement of stocks. However a General principle of market price or cost price whichever is lower followed by accountants. But valuation of stock is another tool in the hands of creative accountants to put glamour to the balance sheet.

3. Verification of provisions:

Generally provisions are created to meet losses or to meet a specific contingency for instance provision for bad debts, discount on debtors, etc. An excessive provision for bad and doubtful debts will lower the income shown in profit and loss account. A trend can be framed so as to put a check on this malpractice. More over creation of provisions is subjective in nature. More conservative accountant will create more provision and vice versa.

4. Verification of Capital and Revenue Items:

A distinction between capital and revenue item is very important from the point of view of calculating the correct profit or loss of a business concern. Window dressing can be done by shifting any capital expenditure from balance sheet to income statement so as to lowering down the profits and vice & versa.

A check is also required to determine whether revenue item is deferred revenue or not. Deferred revenue expenditure is basically a revenue item but the benefit of which will extend beyond the period in which it is incurred.

Reasons for need of window dressing:

1. Window Dressing is done for enhancing liquidity position of the corporate unit.

2. Window Dressing is done for showcase stable profitability of the company.

3. Window Dressing is done for reducing tax liability of the corporate unit.

4. Window Dressing is done to attract more investors.

5. Window Dressing is done to reassure money lenders.

6. Window Dressing sometime is done to ward off take-over bids.

7. Window Dressing is also done to influence market prices of shares of the company.

8. Window Dressing is needed sometimes for hiding poor managerial decisions.

9. Window Dressing is done to satisfy major investors because they feel concerned with desired rate of return.

10. Window Dressing is done for achieving sales and profit targets.

Window Dressing of Income Statement:

A creative accountant can prepare an attractive income statement of an inefficient business firm in such a way that lapse on the part of management can be concealed.

Following are the ways of window dressing in Income Statement:

1. under and over valuation of inventories.

2. Excess/less creation of provision of Bad debts and Discount on Debtors.

3. Excess/Less Depreciation on Fixed assets.

4. Excess/less amortization of fictitious assets.

5. Creation of General Reserve.

6. Showing capital expenditure as a revenue expenditure in income statement.

Window Dressing of Balance Sheet:

Balance sheet being a static statement shows financial position and condition of an organization on a particular date. This statement does not depict the position of the whole accounting period.

Accountant can create a balance sheet on the whims of owner in following ways:

1. under or over valuation of closing stock.

2. Inclusion of obsolete or dead stock.

3. Excess slow moving debtors by adopting liberal credit policies.

4. Showing long term items as short term so as to improve liquidity ratios.

5. Window dressing of portfolios maintained by the firms.

6. Utilization of reserves for issuing bonus shares.

Important ques:

1. Define international accounting and discuss various approaches to its definition.
2. Write a note on international accounting in India.
3. Discuss the progress of standard setting in India.
4. What do you mean by accounting for currency translation? Why is it needed?
5. What do you mean by transfer price? Discuss various methods of transfer pricing.

6. What is the significance of transfer pricing.
7. Write a short note on transfer pricing in India.
8. Explain the difference between IFRS and GAAP
9. Explain IFRS 3
10. Briefly explain the ethical issue faced by MNCs.

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8. **USOL NOTES**

THANK YOU

KARISHMA AGGARWAL