

International Journal of Applied Finance for Non-Financial Managers

Volume 2 Issue 1

A light gray world map is centered on the page, showing the outlines of all continents. The text 'International Accounting Standards' is overlaid on the map, centered over the Atlantic Ocean.

International Accounting Standards

Dr Philip E Dunn

ISSN 1742-528X

IAS 1: Presentation of Financial Statements

Readers will be aware that all EU Companies listed on a regulated market are now required to prepare their consolidated accounts in accordance with endorsed International Accounting Standards .

The IASB – International Accounting Standards Board issued its framework for the Preparation and Presentation of Financial Statements in 1989. This is referred to as its conceptual framework.

The framework sets out the concepts that underline preparation and presentation of financial statements for external users. The IASB framework assists the IASB:

- “in the development of future International Accounting Standards and in its review of existing International Accounting Standards; and
- in promoting the harmonisation of regulations, accounting standards and procedures relating presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards.

In addition, the framework may assist:

- preparers of financial statements in applying International Accounting Standards and in dealing with topics that have yet to form the subject of an International Accounting Standard;
- auditors in forming an opinion as to whether financial statements conform with International Accounting Standards;
- users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Accounting Standards; and
- those who are interested in the work of IASB, providing them with information about its approach to the formulation of accounting standards.”

(IASB Summary of Framework)

The framework establishes the underlying concepts of accounting, some of these concepts are embedded in IAS 1, Presentation of Financial Statements.

Concepts and Policies

The standard contains a number of such accounting principles and conventions that there is a necessity to follow in the preparation of financial statements. It defines overall considerations for financial statements including:

- Fair presentation
- Accounting policies
- Going concern
- Accrual basis of accounting
- Consistency of presentation
- Materiality and aggregation
- Offsetting
- Comparative information

It is interesting to note that these mirror the concepts and conventions included in the former accounting standard SSAP 2 and those now firmly embedded in FRS 18 Accounting Policies issued by the ASB, Accounting Standards Board (UK)

In addition to fundamental principles are their effect on financial statements IAS 1 focuses on the structure and content of the Balance Sheet and Income Statement. It recommends formats for these and in addition requires a statement of changes in equity and a cash flow statement (IAS 7) to accompany the Balance Sheet and Income Statement. These are referred to as the Four Basic Financial Statements.

The suggested format of the Balance Sheet is:

	\$m	\$m
Assets:		
Non current assets:		
Property, plant and equipment	x	
Goodwill	x	
Investments	x	
	<hr/>	x
Current assets:		
Inventories	x	
Trade and other receivables	x	
Prepayments	x	
Cash	x	
	<hr/>	x
Total assets:		<hr/> \$ <hr/>
Equity and Liabilities:		
Capital and reserves:		
Issued capital	x	
Reserves	x	
Accumulated profits	x	
	<hr/>	x
Non current liabilities:		
Loan notes		x
Current liabilities:		
Trade and other payables	x	
Overdrafts	x	
Proposed dividends	x	
Tax provision	x	
	<hr/>	x
Total equity and liabilities		<hr/> \$ <hr/>

NB: Property, plant and equipment and capital and reserves require disclosure notes to show details and movement in the period

Current / Non-current Distinction

The suggested balance sheet format makes a distinction between current and non-current assets and liabilities. The standard specifies rules applicable to this distinction.

Current assets are classified as those which:

- are part of the business entity's operating cycle: or
- are held for trading purposes in the short term and expected to be revised within twelve months of the balance sheet date; or
- are cash and cash equivalent.

All other assets would be classified as non-current assets.

A current liability should be classified as such if it is:

- expected to be discharged in the normal course of the entity's operating cycle: or
- due to be paid within twelve months of the balance sheet date.

All other liabilities would be classified as non-current liabilities.

Income Statement

IAS 1 considers the issue of the presentation of the income statement, which in other national published accounting standards is referred to as the profit and loss account.

The standard distinguishes the function of expense ('by function') and nature of expense ('by nature') formats. As with the European 4th Directive the standard permits both types of presentation as it states that "each method of presentation has merit for different types of enterprise".

The 'by function' format is also referred to as the cost of sales method.

The standard states that it "requires a choice between classifications based on that which most fairly presents the elements of the enterprise's performance" (para 84). A significant feature of the standard which will aid financial analysts with inter-firm comparisons is the requirements to disclose additional information when a 'by function' format is used. The standard states that "Enterprises classifying expenses by function should disclose additional information on the nature of expenses, including depreciation and amortisation expense and staff costs". This would enable analysts to determine value added and other ratios from the financial statements. The 'by nature' format also provides information from which value added can be determined, together with the ratio of value added per \$ of employee costs – a significant measure of productivity.

The two formats – slightly modified for accounting framework – paper 1 level concepts are:

‘By Function’ Format

	\$m
Revenue	x
Cost of sales	(x)
	<hr/>
Gross profit	x
Other operating income	x
Distribution costs	(x)
Administrative expenses	(x)
	<hr/>
Profit from operations	x
Net interest cost	(x)
	<hr/>
Profit before tax	x
Income tax expense	(x)
	<hr/>
Net profit for period	<u>\$ x</u>

‘By Nature’ Format

	\$m	\$m
Revenue		x
Other operating income		x
Changes in inventories of finished goods and work in progress	x	
Raw materials and consumables used	x	
Staff costs	x	
Depreciation and amortisation expense	x	
Other operating expenses	x	
	<hr/>	<hr/>
Profit from operations		x
Net interest cost		x
		<hr/>
Profit before tax		x
Income tax expense		x
		<hr/>
Net profit for period		<u>\$ x</u>

The following example illustrates these two differing formats.

The following is an extract of balances in the accounts of Northcliffe Feeds and Fertilisers a limited company at 31 December 2004.

	\$m
Cost of sales	7.2
Sales revenue	18.2
Distribution costs	2.6
Loan note interest	2.8
Admin expenses	4.2

An analysis of the costs other than interest; ie \$14m showed the following:

	\$m
Raw materials and consumables	4.2
Increase in inventories finished goods and work in progress	(0.4)
Depreciation	3.6
Staff costs	5.8
Other operating expenses	0.8
	<u>14m</u>

The provision for income tax expense had been agreed at \$0.4m. From this information we can now produce income statements in both formats.

'By Function' Format

Northcliffe Feeds and Fertilisers

Income Statement for Year Ended 31 December 2004

	\$m	\$m
Revenue		18.2
Cost of sales		<u>7.2</u>
Gross profit		11.0
Distribution costs	2.6	
Administration expenses	4.2	
		<u>6.8</u>
Profit from operations		4.2
Interest payable		<u>2.8</u>
Profit before tax		1.4
Income tax expense		<u>0.4</u>
Net profit for period		<u>1.0</u>

'By Nature' Format

	\$m	\$m
Revenue		18.2
Increase in inventories of finished goods and work in progress		<u>0.4</u>
		18.6
Raw materials and consumables	4.2	
Staff costs	5.8	
Depreciation	3.6	
Other operating expenses	<u>0.8</u>	
		<u>14.4</u>
Profit from operations		4.2
Interest payable		<u>2.8</u>
Profit before tax		1.4
Income tax expense		<u>0.4</u>
Net profit for period		<u>\$1.0</u>

The ratio of value added per \$ of employee costs referred to above can be easily determined from the 'by nature' format statement.

Value added is defined as sales revenue less the cost of all bought out materials and services and here comprises:

	\$m	\$m
Revenue		18.2
Less:		
Raw materials and consumables	4.2	
Other operating expenses	<u>0.8</u>	
		<u>5.0</u>
		13.2
Add back increase in inventories of finished goods and work in progress		<u>0.4</u>
Value added		<u>13.6</u>
Value added per \$ of employee costs =		2.35

The statement of changes in equity can show either:

- all changes in equity; or
- changes in equity other than those arising from capital transactions with owners and distribution to owners – another way of saying a statement of recognised gains and losses.

The two formats may appear as:

Statement of Changes in Equity for Year Ended 31 December 2004

	Share Capital \$m	Share Premium \$m	Revaluation Reserve \$m	Profit & Loss a/c \$m	Total \$m
Balance 31 December 2003	*	*	*	*	*
Surplus on revaluation of properties			*		*
Deficit on revaluation of investments			(*)		(*)
Net gains and losses not recognised in the income statement			*		*
Net profit for period				*	*
Dividends				(*)	(*)
Issue of Share Capital	*	*			*
Balance at 31 December 2004	*	*	*	*	*

or:

Statement of Recognised Gains and Losses

	\$m
Surplus on revaluation of properties	*
Deficit on revaluation of investments	(*)
Net gains not recognised in the income statement	*
Net profit for period	*
Total recognised gains and losses	*

The above statement of recognised gains and losses is also the requirement of the ASB's Standard FRS 3.

Research suggests that the second of these two statements is more useful to the user groups of financial information as it focuses on the financial performance for the period.

If the statement of recognised gains and losses is presented it is also necessary to include by way of a note a reconciliation of the opening and closing balances on Share Capital, Revaluation Reserve and Profit and Loss a/c.

The fourth of the basic financial statements recognised in IAS 1, the Cash Flow Statement (IAS 7) which was feature in the February copy of the journal.