

---

**CERTIFIED INVESTMENT AND FINANCIAL  
ANALYSTS**

**PART TWO  
SECTION THREE STUDY KIT**

**FINANCIAL STATEMENT ANALYSIS**

---

## Table of contents

<b>CHAPTER ONE.....</b>	<b>3</b>
Standards for the preparation and presentation of financial statements	
<b>CHAPTER TWO.....</b>	<b>50</b>
Other sources of financial information	
<b>CHAPTER THREE.....</b>	<b>54</b>
Analysis of stockholders' equity statement	
<b>CHAPTER FOUR.....</b>	<b>65</b>
Quality earnings and earnings management	
<b>CHAPTER FIVE.....</b>	<b>96</b>
Financial reporting	
<b>CHAPTER SIX.....</b>	<b>116</b>
Financial statements analytical tools	
<b>CHAPTER SEVEN.....</b>	<b>147</b>
Analysis of debt and taxes	
<b>CHAPTER EIGHT.....</b>	<b>162</b>
Analysis of inter-corporate investments	
<b>CHAPTER NINE.....</b>	<b>166</b>
Analysis of business combinations and global operations	
<b>CHAPTER TEN.....</b>	<b>208</b>
Analysis of pension assets and liabilities	
<b>SUMMARIES OF IFRS and IAS.....</b>	<b>225</b>

---

## TOPIC ONE:

# STANDARDS FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

## INTRODUCTION

**Financial statement analysis** is defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account.

There are various methods or techniques that are used in analyzing financial statements, such as comparative statements, schedule of changes in working capital, common size percentages, funds analysis, trend analysis, and ratios analysis.

Financial statements are prepared to meet external reporting obligations and also for decision making purposes. They play a dominant role in setting the framework of managerial decisions. But the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements alone. However, the information provided in the financial statements is of immense use in making decisions through analysis and interpretation of financial statements.

## PRESENTATION OF FINANCIAL STATEMENTS

Sixth schedule to the Companies Act: Accounts

**IFRSs** Gives the guideline on the content and the accounting statements of certain events and transactions in the financial statements. The following IFRSs are relevant for the purpose of preparing published financial statements;

- IAS 1:** - **Presentation of Financial Statements**
- IAS 7:** - **Cashflow statements**
- IAS 8:** - **Accounting policies, changes in accounting estimates and errors**
- IAS 10:** - **Events after the balance sheet date**
- IAS 12:** - **Income Tax**
- IFRS 5** - **Non-current assets held for sale and discontinued operations.**

---

# IAS 1 — Presentation of Financial Statements

## OVERVIEW

IAS 1 *Presentation of Financial Statements* sets out the overall requirements for financial statements, including how they should be structured, the minimum requirements for their content and overriding concepts such as going concern, the accrual basis of accounting and the current/non-current distinction. The standard requires a complete set of financial statements to comprise a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity and a statement of cash flows.

IAS 1 was reissued in September 2007 and applies to annual periods beginning on or after 1 January 2009.

## SUMMARY OF IAS 1

### Objective of IAS 1

The objective of IAS 1 (2007) is to prescribe the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. IAS 1 sets out the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. Standards for recognizing, measuring, and disclosing specific transactions are addressed in other Standards and Interpretations.

### Scope

Applies to all general purpose financial statements based on International Financial Reporting Standards

General purpose financial statements are those intended to serve users who are not in a position to require financial reports tailored to their particular information needs.

### Objective of financial statements

The objective of general purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements provide information about an entity's:

- assets
- liabilities
- equity
- income and expenses, including gains and losses
- contributions by and distributions to owners
- cash flows

---

That information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

## **Components of financial statements**

### **A complete set of financial statements should include:**

- a statement of financial position (balance sheet) at the end of the period
- a statement of comprehensive income for the period (or an income statement and a statement of comprehensive income)
- a statement of changes in equity for the period
- a statement of cash flows for the period
- notes, comprising a summary of accounting policies and other explanatory notes

When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements, it must also present a statement of financial position (balance sheet) as at the beginning of the earliest comparative period.

An entity may use titles for the statements other than those stated above.

Reports that are presented outside of the financial statements – including financial reviews by management, environmental reports, and value added statements – are outside the scope of IFRSs.

## **Fair presentation and compliance with IFRSs**

The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

IAS 1 requires that an entity whose financial statements comply with IFRSs make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs (including Interpretations).

Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework. In such a case, the entity is required to depart from the IFRS requirement, with detailed disclosure of the nature, reasons, and impact of the departure.

**FOR FULL NOTES**  
**CALL/TEXT: 0724 962 477**

---

## **Going concern**

An entity preparing IFRS financial statements is presumed to be a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case IAS 1 requires a series of disclosures.

## **Accrual basis of accounting**

IAS 1 requires that an entity prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

## **Consistency of presentation**

The presentation and classification of items in the financial statements shall be retained from one period to the next unless a change is justified either by a change in circumstances or a requirement of a new IFRS.

## **Materiality and aggregation**

Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial.

## **Offsetting**

Assets and liabilities, and income and expenses, may not be offset unless required or permitted by an IFRS.

## **Comparative information**

IAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard requires otherwise.

If comparative amounts are changed or reclassified, various disclosures are required.

## **Structure and content of financial statements in general**

### **Clearly identify:**

- the financial statements
- the reporting enterprise
- whether the statements are for the enterprise or for a group
- the date or period covered
- the presentation currency
- The level of precision (thousands, millions, etc.)

---

## Reporting period

There is a presumption that financial statements will be prepared at least annually. If the annual reporting period changes and financial statements are prepared for a different period, the entity must disclose the reason for the change and a warning about problems of comparability.

## Statement of Financial Position (Balance Sheet)

An entity must normally present a classified statement of financial position, separating current and non-current assets and liabilities. Only if a presentation based on liquidity provides information that is reliable and more relevant may the current/non-current split be omitted. In either case, if an asset (liability) category combines amounts that will be received (settled) after 12 months with assets (liabilities) that will be received (settled) within 12 months, note disclosure is required that separates the longer-term amounts from the 12-month amounts.

Current assets are cash; cash equivalent; assets held for collection, sale, or consumption within the entity's normal operating cycle; or assets held for trading within the next 12 months. All other assets are non-current.

Current liabilities are those expected to be settled within the entity's normal operating cycle or due within 12 months, or those held for trading, or those for which the entity does not have an unconditional right to defer payment beyond 12 months. Other liabilities are non-current.

When a long-term debt is expected to be refinanced under an existing loan facility and the entity has the discretion the debt is classified as non-current, even if due within 12 months

If a liability has become payable on demand because an entity has breached an undertaking under a long-term loan agreement on or before the reporting date, the liability is current, even if the lender has agreed, after the reporting date and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach. However, the liability is classified as non-current if the lender agreed by the reporting date to provide a period of grace ending at least 12 months after the end of the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

Minimum items on the face of the statement of financial position

- (a) property, plant and equipment
- (b) investment property
- (c) intangible assets
- (d) financial assets (excluding amounts shown under (e), (h), and (i))
- (e) investments accounted for using the equity method
- (f) biological assets
- (g) Inventories
- (h) trade and other receivables

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

- 
- (i) cash and cash equivalents
  - (j) assets held for sale
  - (k) trade and other payables
  - (l) Provisions
  - (m) financial liabilities (excluding amounts shown under (k) and (l))
  - (n) liabilities and assets for current tax
  - (o) deferred tax liabilities and deferred tax assets
  - (p) liabilities included in disposal groups
  - (q) non-controlling interests, presented within equity and
  - (r) issued capital and reserves attributable to owners of the parent

Additional line items may be needed to fairly present the entity's financial position.

IAS 1 does not prescribe the format of the balance sheet. Assets can be presented current then non-current, or vice versa, and liabilities and equity can be presented current then non-current then equity, or vice versa. A net asset presentation (assets minus liabilities) is allowed. The long-term financing approach used in UK and elsewhere – fixed assets + current assets - short term payables = long-term debt plus equity – is also acceptable.

Regarding issued share capital and reserves, the following disclosures are required:

- numbers of shares authorized, issued and fully paid, and issued but not fully paid
- par value
- reconciliation of shares outstanding at the beginning and the end of the period
- description of rights, preferences, and restrictions
- treasury shares, including shares held by subsidiaries and associates
- shares reserved for issuance under options and contracts
- a description of the nature and purpose of each reserve within equity



---

## Format for statement of financial position

Example:

<b>ABC LTD</b>		
<b>STATEMENT OF FINANCIAL POSITION AS AT 31/12/</b>		
<b>NON-CURRENT ASSETS</b>	£	£
Property, plant and equipment		x
Goodwill		x
Other intangible assets		x
Investment Long-term		<u>x</u>
		x
<b>CURRENT ASSETS</b>		
Inventory	x	
Accounts receivables and prepayments	x	
Short-term investment	x	
Cash at bank and in hand	<u>x</u>	<u>x</u>
<b>TOTAL ASSETS</b>		<u><u>xx</u></u>
<b>EQUITY AND LIABILITIES</b>		
Preference share capital		x
Ordinary share capital		<u>x</u>
		x
<b>RESERVES</b>		
Share premium	x	
Revaluation reserve	x	
General reserve	<u>x</u>	x
Retained profits		<u>x</u>
Shareholders' funds		x
<b>NON-CURRENT LIABILITIES</b>		
Loan stock/debentures	x	
Redeemable preference shares	x	
Deferred tax	x	
Other long-term provisions	<u>x</u>	x
<b>CURRENT LIABILITIES</b>		
Bank overdraft	x	
Trade and other payables (accruals)	x	
Current tax (tax payable)	x	
Current portion of loan stock	x	
Prepared dividends (and shares or preference shares)	<u>x</u>	<u>x</u>
<b>TOTAL EQUITY AND LIABILITY</b>		<u><u>xx</u></u>

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

## Statement of Comprehensive Income

Comprehensive income for a period includes profit or loss for that period plus other comprehensive income recognized in that period. As a result of the 2003 revision to IAS 1, the Standard is now using 'profit or loss' rather than 'net profit or loss' as the descriptive term for the bottom line of the income statement.

All items of income and expense recognized in a period must be included in profit or loss unless a Standard or an Interpretation requires otherwise. [IAS 1.88] Some IFRSs require or permit that some components to be excluded from profit or loss and instead to be included in other comprehensive income.

The components of other comprehensive income include:

- changes in revaluation surplus (IAS 16 and IAS 38)
- actuarial gains and losses on defined benefit plans recognized in accordance with IAS 19
- gains and losses arising from translating the financial statements of a foreign operation (IAS 21)
- gains and losses on re-measuring available-for-sale financial assets (IAS 39)
- The effective portion of gains and losses on hedging instruments in a cash flow hedge (IAS 39).

An entity has a choice of presenting:

- a single statement of comprehensive income or
- two statements:
  - an income statement displaying components of profit or loss and
  - a statement of comprehensive income that begins with profit or loss (bottom line of the income statement) and displays components of other comprehensive income

Minimum items on the face of the statement of comprehensive income should include:

- revenue
- finance costs
- share of the profit or loss of associates and joint ventures accounted for using the equity method
- tax expense
- a single amount comprising the total of (i) the post-tax profit or loss of discontinued operations and (ii) the post-tax gain or loss recognized on the disposal of the assets or disposal group(s) constituting the discontinued operation
- profit or loss
- each component of other comprehensive income classified by nature
- share of the other comprehensive income of associates and joint ventures accounted for using the equity method
- total comprehensive income

---

The following items must also be disclosed in the statement of comprehensive income as allocations for the period:

- profit or loss for the period attributable to non-controlling interests and owners of the parent
- total comprehensive income attributable to non-controlling interests and owners of the parent

Additional line items may be needed to fairly present the entity's results of operations. No items may be presented in the statement of comprehensive income (or in the income statement, if separately presented) or in the notes as 'extraordinary items'.

Certain items must be disclosed separately either in the statement of comprehensive income or in the notes, if material, including:

Write-downs of inventories to net realizable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs

- restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring
- disposals of items of property, plant and equipment
- disposals of investments
- discontinuing operations
- litigation settlements
- other reversals of provisions

Expenses recognized in profit or loss should be analyzed either by nature (raw materials, staffing costs, depreciation, etc.) or by function (cost of sales, selling, administrative, etc). If an entity categorizes by function, then additional information on the nature of expenses – at a minimum depreciation, amortization and employee benefits expense – must be disclose

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

Example:

***By function***

<b>ABC LTD</b>		
<b>INCOME STATEMENT FOR THE YEAR ENDED 31/12/</b>		
	£	£
Revenue		x
Cost of sales		<u>(x)</u>
Gross profit		x
Other incomes (e.g. investment income)		<u>x</u>
		x
Expenses		
Distribution costs	x	
Administration costs	x	
Other expenses	x	
Finance costs	<u>x</u>	<u>(x)</u>
Profit before		x
Income tax expense		<u>(x)</u>
Profit for the period		<u><u>xx</u></u>

**By Nature**

<b>ABC LTD</b>		
<b>INCOME STATEMENT FOR THE YEAR ENDED 31/12/</b>		
	£	£
Revenue		x
Other incomes		<u>x</u>
		x
Expenses		
Raw materials consumed	x	
Changes in finished goods and work in progress	x	
Depreciation and amortization	x	
Employee benefits	x	
Other expenses	x	
Finance costs	<u>x</u>	<u>(x)</u>
Profit before tax		x
Income tax expenses		<u>(x)</u>
Profit for the period		<u><u>xx</u></u>

---

## Statement of Cash Flows

Rather than setting out separate standards for presenting the cash flow statement, IAS 1.111 refers to IAS 7 Statement of Cash Flows

## Statement of Changes in Equity

IAS 1 requires an entity to present a statement of changes in equity as a separate component of the financial statements. The statement must show:

- total comprehensive income for the period, showing separately amounts attributable to owners of the parent and to non-controlling interests
- the effects of retrospective application, when applicable, for each component
- reconciliations between the carrying amounts at the beginning and the end of the period for each component of equity, separately disclosing:
  - profit or loss
  - each item of other comprehensive income
  - transactions with owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control

The following amounts may also be presented on the face of the statement of changes in equity, or they may be presented in the notes:

- amount of dividends recognized as distributions, and
- the related amount per share

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

Example:

The format of the statement of changes in equity is given as follows:

	Preference share capital	Ordinary share capital	Share premium	Revaluation reserve	General reserve	Retained profits	TOTAL
	£	£	£	£	£	£	£
Balance at 1.1	x	x	x	x	x	x	x
Changes in a/c policy/correction of error	-	-	-	-	-	(x)	(x)
Balance as restated (i +ii)	x	x	x	x	x	x	x
Gain/losses on revaluation PPE	-	-	-	x	-	-	x
Transfer to retained profits on sale of PPE	-	-	-	(x)	-	x	-
Gain losses on investment revaluation	-	-	-	x	-	-	x
Foreign currency exchange gain/losses	-	-	-	x	-	-	x
Net gains/losses directly reported in equity (iv + v +vi + vii)	-	-	-	x	-	x	x
Profit for the period	-	-	-	-	-	x	x
Total gains/losses recognized during the year (viii + ix)	-	-	-	x	-	x	x
Issue of shares	x	x	x	-	-	-	x
Transfer to general reserve	-	-	-	-	x	(x)	-
Dividends: interim paid	-	-	-	-	-	(x)	(x)
Final proposed (If prop before year end)	-	-	-	-	-	(x)	(x)
Balance as at 31.12 ( x + xi + xii + xiii)	x	x	x	x	x	x	x

The final value of the total should be the same as the shareholder funds in the balance sheet.

---

## Notes to the financial statements

The notes must:

- present information about the basis of preparation of the financial statements and the specific accounting policies used
- disclose any information required by IFRSs that is not presented elsewhere in the financial statements and
- provide additional information that is not presented elsewhere in the financial statements but is relevant to an understanding of any of them

Notes should be cross-referenced from the face of the financial statements to the relevant note. IAS 1.114 suggests that the notes should normally be presented in the following order:

- a statement of compliance with IFRSs
- a summary of significant accounting policies applied, including
  - the measurement basis (or bases) used in preparing the financial statements
  - the other accounting policies used that are relevant to an understanding of the financial statements
- supporting information for items presented on the face of the statement of financial position (balance sheet), statement of comprehensive income (and income statement, if presented), statement of changes in equity and statement of cash flows, in the order in which each statement and each line item is presented
- other disclosures, including:
  - contingent liabilities (see IAS 37) and unrecognized contractual commitments
  - non-financial disclosures, such as the entity's financial risk management objectives and policies (see IFRS 7)

### Disclosure of judgments

New in the 2003 revision to IAS 1, an entity must disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognized in the financial statements.

Examples cited in IAS 1.123 include management's judgements in determining:

- whether financial assets are held-to-maturity investments
- when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities
- whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and
- whether the substance of the relationship between the entity and a special purpose entity indicates control

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

## **Disclosure of key sources of estimation uncertainty**

Also new in the 2003 revision to IAS 1, an entity must disclose, in the notes, information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the end of the reporting period, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. These disclosures do not involve disclosing budgets or forecasts.

The following other note disclosures are required by IAS 1.126 if not disclosed elsewhere in information published with the financial statements:

- domicile and legal form of the entity
- country of incorporation
- address of registered office or principal place of business
- description of the entity's operations and principal activities
- if it is part of a group, the name of its parent and the ultimate parent of the group
- if it is a limited life entity, information regarding the length of the life

## **OTHER DISCLOSURES**

### **Disclosures about dividends**

In addition to the distributions information in the statement of changes in equity (see above), the following must be disclosed in the notes: " the amount of dividends proposed or declared before the financial statements were authorized for issue but not recognized as a distribution to owners during the period, and the related amount per share and " the amount of any cumulative preference dividends not recognized.

### **Capital disclosures**

An entity should disclose information about its objectives, policies and processes for managing capital. To comply with this, the disclosures include:

- qualitative information about the entity's objectives, policies and processes for managing capital, including
  - description of capital it manages
  - nature of external capital requirements, if any
  - how it is meeting its objectives
- quantitative data about what the entity regards as capital
- changes from one period to another
- whether the entity has complied with any external capital requirements and
- If it has not complied, the consequences of such non-compliance.



## Disclosures about puttable financial instruments

A requires the following additional disclosures if an entity has a puttable instrument that is classified as an equity instrument:

- summary quantitative data about the amount classified as equity
- the entity's objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period
- the expected cash outflow on redemption or repurchase of that class of financial instruments and
- Information about how the expected cash outflow on redemption or repurchase was determined.

## Terminology

The 2007 comprehensive revision to IAS 1 introduced some new terminology. Consequential amendments were made at that time to all of the other existing IFRSs, and the new terminology has been used in subsequent IFRSs including amendments. IAS 1.8 states: "Although this Standard uses the terms 'other comprehensive income', 'profit or loss' and 'total comprehensive income', an entity may use other terms to describe the totals as long as the meaning is clear. For example, an entity may use the term 'net income' to describe profit or loss." Also, IAS 1.57(b) states: "The descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position."

<b>Term before 2007 revision of IAS 1</b>	<b>Term as amended by IAS 1 (2007)</b>
balance sheet	<b>statement of financial position</b>
cash flow statement	<b>statement of cash flows</b>
income statement	<b>statement of comprehensive income (income statement is retained in case of a two-statement approach)</b>
recognized in the income statement	<b>recognized in profit or loss</b>
recognized [directly] in equity (only for OCI components)	<b>recognized in other comprehensive income</b>
recognized [directly] in equity (for recognition both in OCI and equity)	<b>recognized outside profit or loss (either in OCI or equity)</b>
removed from equity and recognized in profit or loss ('recycling')	<b>reclassified from equity to profit or loss as a reclassification adjustment</b>
Standard or/and Interpretation	<b>IFRSs</b>
on the face of	<b>in</b>
equity holders	<b>owners (exception for 'ordinary equity holders')</b>
balance sheet date	<b>end of the reporting period</b>
reporting date	<b>end of the reporting period</b>
after the balance sheet date	<b>after the reporting period</b>

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

## June 2011: IASB issued amendments to IAS 1

### **Amendments to IAS 1 *Presentation of Financial Statements***

- Preserve the amendments made to IAS 1 in 2007 to require profit or loss and OCI to be presented together, i.e. either as a single statement of comprehensive income, or separate income statement and a statement of comprehensive income — rather than requiring a single continuous statement as was proposed in the exposure draft
- Require entities to group items presented in OCI based on whether they are potentially reclassifiable to profit or loss subsequently. i.e. those that might be reclassified and those that will not be reclassified
- Require tax associated with items presented before tax to be shown separately for each of the two groups of OCI items (without changing the option to present items of OCI either before tax or net of tax)
- Applicable to annual periods beginning on or after 1 July 2012, with early adoption permitted.

---

## IAS 7 — Statement of Cash Flows

IAS 7 *Statement of Cash Flows* requires an entity to present a statement of cash flows as an integral part of its primary financial statements. Cash flows are classified and presented into operating activities (either using the 'direct' or 'indirect' method), investing activities or financing activities, with the latter two categories generally presented on a gross basis.

IAS 7 was reissued in December 1992, retiled in September 2007, and is operative for financial statements covering periods beginning on or after 1 January 1994.

### SUMMARY OF IAS 7

#### Objective of IAS 7

The objective of IAS 7 is to require the presentation of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows, which classifies cash flows during the period according to operating, investing, and financing activities.

#### Fundamental principle in IAS 7

All entities that prepare financial statements in conformity with IFRSs are required to present a statement of cash flows.

The statement of cash flows analyses changes in cash and cash equivalents during a period. Cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash and that are subject to an insignificant risk of changes in value. Guidance notes indicate that an investment normally meets the definition of a cash equivalent when it has a maturity of three months or less from the date of acquisition. Equity investments are normally excluded, unless they are in substance a cash equivalent (e.g. preferred shares acquired within three months of their specified redemption date). Bank overdrafts which are repayable on demand and which form an integral part of an entity's cash management are also included as a component of cash and cash equivalents.

#### Presentation of the Statement of Cash Flows

Cash flows must be analyzed between operating, investing and financing activities.

Key principles specified by IAS 7 for the preparation of a statement of cash flows are as follows:

- **operating activities** are the main revenue-producing activities of the entity that are not investing or financing activities, so operating cash flows include cash received from customers and cash paid to suppliers and employees

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

- **investing activities** are the acquisition and disposal of long-term assets and other investments that are not considered to be cash equivalents
- **financing activities** are activities that alter the equity capital and borrowing structure of the entity
- interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period
- cash flows arising from taxes on income are normally classified as operating, unless they can be specifically identified with financing or investing activities
- For operating cash flows, the direct method of presentation is encouraged, but the indirect method is acceptable

the **direct method** shows each major class of gross cash receipts and gross cash payments. The operating cash flows section of the statement of cash flows under the direct method would appear something like this:

Cash receipts from customers	xx,xxx
Cash paid to suppliers	xx,xxx
Cash paid to employees	xx,xxx
Cash paid for other operating expenses	xx,xxx
Interest paid	xx,xxx
Income taxes paid	xx,xxx
<b>Net cash from operating activities</b>	<b>xx,xxx</b>

- The **indirect method** adjusts accrual basis net profit or loss for the effects of non-cash transactions. The operating cash flows section of the statement of cash flows under the indirect method would appear something like this:

Profit before interest and income taxes	xx,xxx
Add back depreciation	xx,xxx
Add back amortization of goodwill	xx,xxx
Increase in receivables	xx,xxx
Decrease in inventories	xx,xxx
Increase in trade payables	xx,xxx
Interest expense	xx,xxx
Less Interest accrued but not yet paid	xx,xxx
Interest paid	xx,xxx
Income taxes paid	xx,xxx
<b>Net cash from operating activities</b>	<b>xx,xxx</b>

- the exchange rate used for translation of transactions denominated in a foreign currency should be the rate in effect at the date of the cash flows

- 
- cash flows of foreign subsidiaries should be translated at the exchange rates prevailing when the cash flows took place
  - as regards the cash flows of associates and joint ventures, where the equity method is used, the statement of cash flows should report only cash flows between the investor and the investee; where proportionate consolidation is used, the cash flow statement should include the venture's share of the cash flows of the investee
  - Aggregate cash flows relating to acquisitions and disposals of subsidiaries and other business units should be presented separately and classified as investing activities, with specified additional disclosures. The aggregate cash paid or received as consideration should be reported net of cash and cash equivalents acquired or disposed of.
  - cash flows from investing and financing activities should be reported gross by major class of cash receipts and major class of cash payments except for the following cases, which may be reported on a net basis:
    - cash receipts and payments on behalf of customers (for example, receipt and repayment of demand deposits by banks, and receipts collected on behalf of and paid over to the owner of a property)
    - cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short, generally less than three months (for example, charges and collections from credit card customers, and purchase and sale of investments)
    - cash receipts and payments relating to deposits by financial institutions
    - cash advances and loans made to customers and repayments thereof
  - investing and financing transactions which do not require the use of cash should be excluded from the statement of cash flows, but they should be separately disclosed elsewhere in the financial statements
  - the components of cash and cash equivalents should be disclosed, and a reconciliation presented to amounts reported in the statement of financial position
  - the amount of cash and cash equivalents held by the entity that is not available for use by the group should be disclosed, together with a commentary by management

## **IAS 8 — Accounting Policies, Changes in Accounting Estimates and Errors**

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is applied in selecting and applying accounting policies, accounting for changes in estimates and reflecting corrections of prior period errors.

The standard requires compliance with any specific IFRS applying to a transaction, event or condition, and provides guidance on developing accounting policies for other items that result in relevant and reliable information. Changes in accounting policies and corrections of errors are generally retrospectively accounted for, whereas changes in accounting estimates are generally accounted for on a prospective basis.

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

## SUMMARY OF IAS 8

### KEY DEFINITIONS

- **Accounting policies** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
- **A change in accounting estimate** is an adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the expected future benefits and obligations associated with that asset or liability.
- **International Financial Reporting Standards** are standards and interpretations adopted by the International Accounting Standards Board (IASB). They comprise:
  - International Financial Reporting Standards (IFRSs)
  - International Accounting Standards (IASs)
  - Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC) and approved by the IASB.
- **Materiality.** Omissions or misstatements of items are material if they could, by their size or nature, individually or collectively; influence the economic decisions of users taken on the basis of the financial statements.
- **Prior period errors** are omissions from, and misstatements in, an entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that was available and could reasonably be expected to have been obtained and taken into account in preparing those statements. Such errors result from mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

### Selection and application of accounting policies

When a Standard or an Interpretation specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item must be determined by applying the Standard or Interpretation and considering any relevant Implementation Guidance issued by the IASB for the Standard or Interpretation.

In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management must use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement, management must refer to, and consider the applicability of, the following sources in descending order:

- the requirements and guidance in IASB standards and interpretations dealing with similar and related issues; and
- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.

Management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting

---

literature and accepted industry practices, to the extent that these do not conflict with the sources.

### **Consistency of accounting policies**

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorization of items for which different policies may be appropriate. If a Standard or an Interpretation requires or permits such categorization, an appropriate accounting policy shall be selected and applied consistently to each category.

### **Changes in accounting policies**

An entity is permitted to change an accounting policy only if the change:

- is required by a standard or interpretation; or
- Results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance, or cash flows.

Note that changes in accounting policies do not include applying an accounting policy to a kind of transaction or event that did not occur previously or were immaterial.

If a change in accounting policy is required by a new IASB standard or interpretation, the change is accounted for as required by that new pronouncement or, if the new pronouncement does not include specific transition provisions, then the change in accounting policy is applied retrospectively.

Retrospective application means adjusting the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

- However, if it is impracticable to determine either the period-specific effects or the cumulative effect of the change for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.
- Also, if it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

## Disclosures relating to changes in accounting policies

Disclosures relating to changes in accounting policy caused by a new standard or interpretation include:

- the title of the standard or interpretation causing the change
- the nature of the change in accounting policy
- a description of the transitional provisions, including those that might have an effect on future periods
- for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
  - for each financial statement line item affected, and
  - for basic and diluted earnings per share (only if the entity is applying IAS 33)
- the amount of the adjustment relating to periods before those presented, to the extent practicable
- If retrospective application is impracticable, an explanation and description of how the change in accounting policy was applied.

Financial statements of subsequent periods need not repeat these disclosures.

Disclosures relating to voluntary changes in accounting policy include:

- the nature of the change in accounting policy
- the reasons why applying the new accounting policy provides reliable and more relevant information
- for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
  - for each financial statement line item affected, and
  - for basic and diluted earnings per share (only if the entity is applying IAS 33)
- the amount of the adjustment relating to periods before those presented, to the extent practicable
- if retrospective application is impracticable, an explanation and description of how the change in accounting policy was applied.

**Financial statements of subsequent periods need not repeat these disclosures.**

If an entity has not applied a new standard or interpretation that has been issued but is not yet effective, the entity must disclose that fact and any and known or reasonably estimable information relevant to assessing the possible impact that the new pronouncement will have in the year it is applied.



---

## **Changes in accounting estimates**

The effect of a change in an accounting estimate shall be recognized prospectively by including it in profit or loss in:

- the period of the change, if the change affects that period only, or
- The period of the change and future periods, if the change affects both.

However, to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognized by adjusting the carrying amount of the related asset, liability, or equity item in the period of the change.

## **Disclosures relating to changes in accounting estimates**

Disclose:

- The nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods
- If the amount of the effect in future periods is not disclosed because estimating it is impracticable, an entity shall disclose that fact. [IAS 8.39-40]

## **Errors**

The general principle in IAS 8 is that an entity must correct all material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by:

- restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

However, if it is impracticable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity must restate the opening balances of assets, liabilities, and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).

Further, if it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity must restate the comparative information to correct the error prospectively from the earliest date practicable.

---

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

## **Disclosures relating to prior period errors**

Disclosures relating to prior period errors include:

- the nature of the prior period error
- for each prior period presented, to the extent practicable, the amount of the correction:
  - for each financial statement line item affected, and
  - for basic and diluted earnings per share (only if the entity is applying IAS 33)
- the amount of the correction at the beginning of the earliest prior period presented
- If retrospective restatement is impracticable, an explanation and description of how the error has been corrected.

## **INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS (IPSAS)**

International Public Sector Accounting Standards (IPSAS) are a set of accounting standards issued by the IPSAS Board for use by public sector entities around the world in the preparation of financial statements. These standards are based on International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

### **Objective**

IPSAS aims to improve the quality of general purpose financial reporting by public sector entities, leading to better informed assessments of the resource allocation decisions made by governments, thereby increasing transparency and accountability.

### **Scope**

IPSAS are accounting standards for application by national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards and commissions). IPSAS standards are widely used by intergovernmental organizations. IPSAS do not apply to government business enterprises.

### **Due process**

IPSAS are issued by IPSASB (International Public Sector Accounting Standards Board), an independent organ of IFAC (International Federation of Accountants). The IPSASB adopts a due process for the development of IPSAS that provides the opportunity for comment by interested parties including auditors, preparers (including finance ministries), standard setters, and individuals. IPSASB meetings to discuss the development and to approve the issuance of IPSAS or other papers are open to the public. Agenda papers, including the minutes of the meetings of the IPSASB, are published on the IPSASB's website: [www.ipsasb.org](http://www.ipsasb.org). Observers on the IPSASB meetings include ADB, EU, IASB, IMF, INTOSAI, OECD, UN, UNDP and the World Bank.

---

## Convergence of IPSAS with IFRS

IPSAS are based on the International Financial Reporting Standards (IFRS), formerly known as IAS. IFRS are issued by the International Accounting Standards Board (IASB). IPSASB adapts IFRS to a public sector context when appropriate. In undertaking that process, the IPSASB attempts, wherever possible, to maintain the accounting treatment and original text of the IFRS unless there is a significant public sector issue which warrants a departure.

## IFRS 4 INSURANCE CONTRACTS

IFRS 4 *Insurance Contracts* applies, with limited exceptions, to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. In light of the IASB's comprehensive project on insurance contracts, the standard provides a temporary exemption from the requirements of some other IFRSs, including the requirement to consider IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when selecting accounting policies for insurance contracts.

IFRS 4 was issued in March 2004 and applies to annual periods beginning on or after 1 January 2005.

### Summary of IFRS 4

#### Background

IFRS 4 is the first guidance from the IASB on accounting for insurance contracts – but not the last. A Second Phase of the IASB's Insurance Project is under way. The Board issued IFRS 4 because it saw an urgent need for improved disclosures for insurance contracts, and some improvements to recognition and measurement practices, in time for the adoption of IFRS by listed companies throughout Europe and elsewhere in 2005.

#### Scope

IFRS 4 applies to virtually all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. [IFRS 4.2] It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. [IFRS 4.3] Furthermore, it does not address accounting by policyholders. [IFRS 4.4(f)]

In 2005, the IASB amended the scope of IAS 39 to include financial guarantee contracts issued. However, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts. [IFRS 4.4(d)]

---

**FOR FULLNOTES**

**CALL/TEXT:0724 962 477**

---

## Definition of insurance contract

An insurance contract is a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

[IFRS 4. Appendix A]

## Accounting policies

The IFRS exempts an insurer temporarily (until completion of Phase II of the Insurance Project) from some requirements of other IFRSs, including the requirement to consider IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in selecting accounting policies for insurance contracts. However, the standard: [IFRS 4.14]

- prohibits provisions for possible claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions)
- requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets
- requires an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and prohibits offsetting insurance liabilities against related reinsurance assets and income or expense from reinsurance contracts against the expense or income from the related insurance contract

## Changes in accounting policies

IFRS 4 permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant. [IFRS 4.22] In particular, an insurer cannot introduce any of the following practices, although it may continue using accounting policies that involve them: [IFRS 4.25]

- measuring insurance liabilities on an undiscounted basis
- measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current market-based fees for similar services
- using non-uniform accounting policies for the insurance liabilities of subsidiaries

## Re-measuring insurance liabilities

The IFRS permits the introduction of an accounting policy that involves remeasuring designated insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities. [IFRS 4.24]

---

## **Prudence**

An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence. [IFRS 4.26]

## **Future investment margins**

There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts. [IFRS 4.27]

## **Asset classifications**

When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets as 'at fair value through profit or loss'.

## **Other issues**

The standard:

- clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract
- requires an insurer to unbundle (that is, to account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet
- clarifies the applicability of the practice sometimes known as 'shadow accounting'
- permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer
- addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments

## **Disclosures**

The standard requires disclosure of:

- information that helps users understand the amounts in the insurer's financial statements that arise from insurance contracts:
  - accounting policies for insurance contracts and related assets, liabilities, income, and expense
  - the recognised assets, liabilities, income, expense, and cash flows arising from insurance contracts
  - if the insurer is a cedant, certain additional disclosures are required
  - information about the assumptions that have the greatest effect on the measurement of assets, liabilities, income, and expense including, if practicable, quantified disclosure of those assumptions

**FOR FULL NOTES**

**CALL/TEXT: 0724 962 477**

- 
- the effect of changes in assumptions
  - reconciliations of changes in insurance liabilities, reinsurance assets, and, if any, related deferred acquisition costs
  - Information that helps users to evaluate the nature and extent of risks arising from insurance contracts:
    - risk management objectives and policies
    - those terms and conditions of insurance contracts that have a material effect on the amount, timing, and uncertainty of the insurer's future cash flows
    - information about insurance risk (both before and after risk mitigation by reinsurance), including information about:
      - the sensitivity to insurance risk
      - concentrations of insurance risk
      - actual claims compared with previous estimates
    - the information about credit risk, liquidity risk and market risk that IFRS 7 would require if the insurance contracts were within the scope of IFRS 7
    - information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value

#### **Rating agency analysis of IFRS 4**

Fitch Ratings – a leading global fixed income rating agency – has analysed the implications of IFRS 4 *Insurance Contracts* and has concluded that Fitch "does not expect any rating actions as a direct result of the move to IFRS. However, Fitch cannot rule out the possibility that the additional disclosure and information contained in the accounts could lead to rating changes due to an improved perception of risk based on the enhanced information available." The special report *Mind the GAAP: Fitch's View on Insurance IFRS* provides an overview of IFRS 4 and the issues being addressed in Phase II of the IASB's insurance project; assesses the implications including increased volatility, greater use of discounting and fair values, changes to income recognition, and enhanced disclosures; and discusses how the changes affect ratings analysis. An excerpt:

Fitch welcomes the progress made by the IASB towards standards that will be more transparent and comparable across regions. The agency recognises the significant limitations of phase 1 but believes that the enhanced disclosure and greater consistency at phase 1 of the insurance accounting project (set out in IFRS 4) will aid in the analysis of insurers and is a useful stepping stone to the more valuable phase 2.

THIS IS A FREE SAMPLE OF THE ACTUAL NOTES TO GET FULL/COMPLETE  
NOTES:

Call/Text/Whatsapp:0724 962 477

You can also write to us at: [24sevenstudy@gmail.com](mailto:24sevenstudy@gmail.com)

To download more resources visit: <http://www.mykasnebnote.com>

For updates and insights like us on [Facebook](#)

STUDY NOTES|REVISION KITS|PILOT PAPERS|COURSE OUTLINE|STUDY TIPS|