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Introduction

Accounting, used in this context to mean the recording and presentation of business events in traditional financial statements (the balance sheet, profit & loss account or income statement), is believed by many to be an exact science. For many accountants, rules (though not all are written down), convention and practice mean that events will always be recorded correctly and presented fairly.

However, several difficulties present themselves: there are genuine differences in opinion as to exactly how events should be recorded and presented; there is also the possibility of distorting both the recording and the presentation; and finally, there is the question of what transactions and events should be included in each set of financial statements.

Therefore there is a fundamental need for the existence and application of Accounting Standards. There is the need for consistency throughout the business world, the prevention of misleading presentation and disclosure of events.

The purpose of this text

The purpose of this text is to explain the principles of extant International Accounting Standards (IAS). These have been re-titled International Financial Reporting Standards (IFRS) as new Standards are introduced and collectively IAS's and the more recent IFRS's are known as IFRS's.

The text is aimed at: anyone in business who has to interface with published accounts and internal reports; or who is responsible for reports that are affected by or lead to published accounts. As never before, professional advisers, directors and executive officers from functions other than finance are affected by the requirements of Accounting Standards. Accountants and students of accountancy will also find this text useful as a summary of Accounting Standards, as it cuts through to exactly what the Standards aim to achieve and thus what has to be accounted for and disclosed.

Why do we need Accounting Standards?

There are different views on how to account for and report business transactions. These may be due to cultural or commercial reasons or because of legislative or taxation laws. A prime aim of Accounting Standards is to bring consistency of reporting within and between countries. Investors and others using financial statements (for example, for investing or benchmarking purposes) can then make decisions based on consistently prepared data.

However, consistency is not the only reason why Accounting Standards are needed. There can be poor or down right bad accounting. Poor accounting may mean lack of exactness giving a wide range of values or inadequate disclosure. Bad accounting could mean fraud.

Why do YOU need to understand Accounting Standards?

Owners, directors, managers and professional advisers, such as lawyers, have a responsibility to understand how business activities are presented in the financial statements – i.e. is the reality of what is going on in the business being properly and fairly presented. To appreciate if this is the case an understanding of the requirements is needed.

Where is IFRS today? Where is IFRS heading?

IFRS is well (or maybe that should be fairly well!) established in the EU and many other countries. China and India are well underway in establishing the use of IFRS. The US has indicated that IFRS will become acceptable from 2011 or 2014 (depending to whom you talk!). However, there are difficulties and dissenters to further (or in some cases full) adoption and proper consistent convergence of national standards to IFRS.

To many of the regulators, the standard setters and those of an economic, theoretical, or academic persuasion the Framework on which the standards are based and the thinking that emanates from this is the 'true way' – just believe the framework's thinking and all will be well.

It is easy to carp and criticise but would any of us like to devise and write them?

The Standards are being revised and developed and there are will be some shocks – further significant changes to practice are mooted, for example, on the accounting for leases and for long-term contract work in progress (construction contracts). For both of these topics some critics maintain that overly theoretical or impractical approaches to accounting are being suggested.

This may be the case but any new IFRS does go through a fairly lengthy and open development process with ample opportunity for comment.

Some issues are 'issues of the day', real or perceived issues arising in response to rogue accounting that most accountants would never contemplate. Thus content and demands of the standards can sometimes seem unbalanced.

Much accounting and disclosure will be redundant for straightforward businesses. The Standards (particularly those concerned with financial instruments) have to try to cover every eventuality arising from the 'clever' gamblers and other 'smart' business school alumni.

It is not the purpose of this text to rehearse the arguments for and against IFRS as it is today. However, we all need to be aware of the issues that prevent faster and more consistent adoption of IFRS and we all MUST understand the IFRS's already in existence.

Layout and how to use the book

Each chapter will contain the following sections:

A **Key Points**
What the Standard is about

B **What is in the Standard**
The list as set out in the actual Standard or Framework

C **Why Needed**
A brief explanation in simple terms of why a standard is needed

D **Ideas – concepts**
The accounting issues and any underlying concepts that have to be addressed

E **Key Content of the Standard**
The key content of the Standard – with explanation if needed

F **Significant differences in GAAP**
The main differences, if any, between IFRS, US and UK GAAP

How to use the book

- If you want to get a feel for what the Standards cover and issues to be addressed read A from each chapter.
- If you need to know more – scan section B and read C and D.
- For a more detailed understanding read E.
- If convergence with UK GAAP is an issue for you or you have to deal with financial statements produced under US GAAP read F.
- To use IFRS in practice you will have to access the IASB published documents – and possibly seek professional help.

Barriers to understanding

Terminology

A barrier to understanding accounting is the differing terminology and statement layouts commonly used. Whilst there has been some success in, for example, Standardising EU financial statement terminology and layouts (appropriately translated), there remains much diversity. Accounting Standards should drive further standardisation in the use of words and statement layout but different practices will remain. This is due to differences in custom, cultural differences or the sloppy use of English. For example: in the UK we say stock, in the US and under IFRS it would be inventory.

In this text the words from the Standards are used as far as possible, but common UK terminology is also frequently used. Thus profit & loss account is used as well as income statement; business or company, as well as entity.

Thought was given to using only the IFRS 'word' but in practice readers will need to contend with different terminology. The everyday words are often synonymous but there may be subtleties in different word usage.

Lesson: If in doubt check exactly how a word is being used.

Understanding financial statement and accounting practices

Further support can be found at the end of the book where there are review chapters covering:

- What balance sheets, profit and loss accounts (income or earnings statements) and cash flow statements aim to convey. The effect of the principal different national differences in components and layouts is explained.
- The use of financial statements as a basis or interpreting a business by carrying out ratio analysis is also outlined.

- An explanation of the need for and rationale behind accounting for and disclosure of financial instruments.
- Finally, the effect on analysis through distortions in accounting method and layout is demonstrated by examples of 'creative accounting' – although of course if accounting standards are based on clear principles there should be little room for interpreting how they should be applied.

Order of chapters

The majority of Accounting Standards were issued and have often been re-issued in response to an event – a significant lapse in proper accounting and disclosure. Thus the chronological or numerical order of the Standards follows little logic (in any event it is questionable as to whether academics or practitioners could agree to a logical order). The history of the development of individual Accounting Standards often illustrates why Standards are needed.

The Standards are dealt with in the following groupings, the aim being to make the study of the Accounting Standards more coherent. If a particular Standard or issue has to be understood then the table below or the contents list should lead the reader to the topic.

	IAS/IFRS number
The Framework, financial statements, accounting concepts and policies	
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Summary objectives and requirements of the Standards

Financial statements, Accounting policies and other disclosure issues

IAS 1 – Presentation of financial statements

Financial statements should have standard minimum content and the basis upon which the figures are prepared should be explained.

The Standard sets out the minimum contents of financial statements: balance sheet, income statement, cash flow statement, significant accounting policies, statement of changes in equity and supporting notes where appropriate.

The Standard reiterates the fundamental accounting concepts of going concern and accruals and their place in the accounting framework.

IAS 8 – Accounting policies, changes in accounting estimates and errors

There needs to be clear criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. The Standard is intended to enhance the relevance, reliability and comparability of an entity's financial statements.

Disclosures (of significant information)

IAS 10 – Events occurring after the balance sheet date

Events may affect a company after the year's end but before accounts are 'signed off'. Events may not cause change to figures in the financial statements, however, to ignore them may be misleading to users of the financial statements.

The Standard requires that significant events after the balance sheet date should be reported by way of note(s) to the accounts.

IAS 24 – Related party disclosures

Who really owns and controls the business? This is vital information if all those involved with the business are to be treated fairly.

The Standard requires disclosure of who really owns and controls the business (related parties) along with details of transactions and balances between the business and these related parties.

IFRS 1 – First time application of IAS's

Businesses adopting IFRS's should comply with them. The Standard requires an entity to use the same (IFRS compliant) accounting policies in its opening IFRS balance sheet and throughout all periods presented in its first IFRS financial statements.

IAS 34 – Interim financial reporting

Interim financial reports must contain a minimum amount of reliable information.

The Standard requires that interim financial statements should contain the same individual reports and use the same accounting policies as the annual statutory accounts. It may be practical and acceptable to demand less detail in some of the disclosures and notes.

The Standard requires the disclosure of material one-off items, including the costs of discontinuing operations. Non-current (fixed) assets that are to be sold should be disclosed separately in the balance sheet.

Profit & Loss Account – Income Statement

IAS 18 – Revenue

The primary issue in accounting for revenue is determining when to recognise revenue – when sales have been irrevocably earned.

The Standard requires that revenue only be recognised when quantifiable inflows (of cash) will definitely occur. The Standard identifies the circumstances by which these criteria will be met and, therefore, revenue can be recognised. It also provides practical guidance on the application of the criteria.

IAS 21 – The effects of changes in foreign exchange rates

Currency gains and losses can be realised or unrealised, many different rates could be used for translation purposes, and gains or losses could be shown in different places in the accounts.

The Standard requires that transactions should be translated at the rate ruling at the date of the transaction. Balance sheet figures should be translated at the rate ruling at the balance sheet date. For non-monetary assets and liabilities the historical rate should be used.

IAS 19 – Employee benefits

The cost of employee benefits to a business should be disclosed, particularly the cost of pension liabilities.

The Standard requires disclosure of all significant classes of employee benefits, but particularly pension contributions. The Standard requires disclosure of contributions to both defined contribution and defined benefit schemes. For defined benefit schemes the adequacy of funding has to be calculated and any liability due to under-funding disclosed.

IFRS 2 – Shared Based Payment

Entities often grant shares or share options to employees or other parties. Without calculation of the cost of the payment and full disclosure of long-term effects such payments may appear ‘free’. Awarding shares or share options means that a portion of the value of the company is being given away.

The Standard requires that a value is put on the cost of awarding share based payments and that the cost is recognised immediately in profit and loss.

IAS 23 – Borrowing costs

Borrowing costs relate to funding businesses and should be charged against income as incurred. However, fixed assets often require considerable funds to finance their construction. Borrowing or interest costs may be considered a cost specifically incurred to bring the asset into revenue earning condition – under strict conditions the costs may be capitalised.

The Standard requires that borrowing costs should be capitalised (included as a cost of the fixed asset) when they are directly attributable to the acquisition, construction or production of a fixed asset.

IAS 20 – Accounting for government grants

Grants may be given to support day-to-day operations – revenue, or to encourage investment in fixed assets – capital. The correct classification is important.

The Standard requires the correct matching of grant credits either as revenue items or capital items. Specifically, capital grants (for equipment etc.) should be spread over the life of the asset and not taken as income.

IAS 12 – Income taxes/current tax/deferred tax

An explanation of the bases for tax charges or credits and where they are recognised in the financial statements is needed. Provision should be made for future tax liabilities that will arise on the reversal of timing differences between accounts and tax charges.

The Standard requires an explanation of the relationship between tax expense or income and accounting profit. It also requires an explanation of changes in the applicable tax rate(s) compared with the previous accounting period.

The Standard requires that a deferred tax liability should be recognised for all taxable temporary differences and charged to the income statement. A deferred tax asset should be recognised to the extent that it is probable that taxable profit will be available in the future against which to recover tax or reduce liability.

IFRS 5 – Non-current assets held for sale and discontinued operations

Profits and losses should generally be taken to the income statement with any large one-off items disclosed separately, particularly the effects of discontinuing operations.

The Standard requires the disclosure of material one-off items, including the costs of discontinuing operations. Non-current (fixed) assets that are to be sold should be disclosed separately in the balance sheet. Also the reporting of errors or alterations to the figures due to changes in accounting policies should be disclosed.

IAS 33 – Earnings per share

An earnings per share ratio is considered an important ratio. If there was no clear definition then this ratio could be misrepresented.

This Standard prescribes the basis for calculating and presenting earnings and other amounts per share in the financial statements of publicly quoted entities.

Balance Sheet

IAS 16 – Property plant and equipment

Tangible fixed assets are a major part of capital employed for the many businesses. They should be carried at cost, or if revalued then this should be done so on a consistent basis.

The Standard codifies much of existing accounting practice. Assets may be carried at cost or revalued. Fixed assets (except land) should be depreciated over reasonable periods.

IAS 40 – Investment property

Investment properties are held for gain, not consumption. It is inappropriate to depreciate them, but they should be revalued to up-to-date fair value.

The Standard requires that investment properties should not be depreciated but shown at fair value.

IAS 38 – Intangible assets

Intangible assets are important for many businesses and in spite of difficulties in valuing them they should be recognised in the balance sheet as assets at cost. The cost should be amortised over reasonable periods or checked annually for impairment in value.

The Standard requires that purchased goodwill and intangible assets are capitalised at cost but reviewed annually for impairment. Own generated intangibles such as brands, patents etc. must not be capitalised in the balance sheet.

IAS 36 – Impairment of assets

There is a need to have some 'science' to ensure assets carried in the balance sheet at fair value have not lost value due to changes in economic circumstances. This Standard aims to provide the framework for prudently valuing goodwill, intangibles and also tangible fixed assets.

The Standard requires a review for impairment of a fixed asset or goodwill to be carried out if events, or changes in circumstances, indicate that the carrying amount of the fixed asset or goodwill may not be recoverable.

Then if, and only if, the recoverable amount of an asset is less than its carrying amount, its carrying amount should be reduced to its recoverable amount. The resultant impairment loss should be recognised in the income statement or against any previous revaluation of the same asset.

IAS 2 – Inventories/stock

Stock and short-term work in progress values are critical to the reporting of profits or losses at the correct amount and in the correct period. Clear definition of terms and defined accounting is required.

The Standard requires that inventories/stock be valued at cost or net realisable value. The method of measuring stock should be to value each item at historical cost, or as close an approximation as is possible.

IAS 11 – Construction contracts/Long-term WIP

The valuation of construction contracts or long-term work in progress is critical to the reporting of balance sheet values and profits or losses – definition of terms and defined accounting is required.

The Standard requires that when the outcome of a construction contract can be estimated with reasonable reliability, revenue and costs should be recognised by reference to the stage of construction. If it is probable that total costs will exceed total revenue, the expected contract loss should be recognised as an expense immediately. The amounts of revenue from contracts and the method of recognising this revenue should be disclosed.

IAS 17 – Leases

The substance of what is going on in business is more important than simply reporting the legal form of transactions. A commitment to make payments for a number of years for the use of an asset means you effectively own the asset BUT also have the contra liability.

The Standard requires that leased, hired or rented assets should be shown as assets of the lessee along with the related liability – the obligation to make lease payments.

IAS 37 – Provisions, contingent liabilities and contingent assets

Provisions should be made only when there is certainty of a future liability. Other potential but nebulous liabilities (or assets) should be quantified and disclosed as contingent liabilities.

The Standard accepts the business and commercial need for provisions but brings definition as to when and how provisions should be sanctioned. The Standard demands a high degree of certainty as to cause and amount before provisions can be made.

Cash flow statements

IAS 7 – Statement of cash flows

Cash flow statements should present the business from the perspective of how it generates and consumes cash and how it is funded.

The Standard requires disclosure of historical changes in cash and cash equivalents of an enterprise by means of a statement which classifies cash flows in and out during the period that arise from operating, investing and financing activities.

Financial Instruments

IAS 32 – Financial instruments: Disclosure and presentation

IAS 39 – Financial Instruments: Recognition and measurement

IFRS 7 – Financial Instruments: Disclosures

What is debt (loans) and what is equity (risk capital)? What financial risk has a business entered into by dealing in derivatives – hedges, futures etc?

The Standards aim to define what is not equity. The Standards require disclosure of information that can help identify the risks a business has in respect of financial instruments. Where possible financial assets should be revalued to fair value at the balance sheet date. Hedging (netting of gains and losses) is allowed under strict conditions.

Accounting for groups and investments

IFRS 3 – Business combinations

IAS 27 – Consolidated and separate financial statements

Businesses acquire other businesses – acquisitions. The difference between purchase price and fair value of assets acquired is goodwill which should be disclosed in the balance sheet of the group, carried at cost, but tested each year for any impairment.

The Standards imply that acquisition accounting with the calculation and disclosure of goodwill should be the norm. Consolidated group accounts should be produced. Merger accounting is prohibited.

The Standards aim to define at what date an acquisition should be accounted for. Values used should be fair values and any resulting goodwill should be carried at cost, tested for impairment but NOT written off over a number of years.

IAS 28 – Accounting for investments in associates

IAS 31 – Financial reporting of interests in joint ventures

A company could own 1%, 14%, 38% etc. of another company. The issue is how should the net assets and results of these different levels of ownership be accounted for? Definition is needed for the varying levels of investment and control.

The Standards define the treatment of a business's investments in other companies. There needs to be a clear and consistently applied distinction between control (a subsidiary) and other levels of investment and influence on the owned entity.

IFRS 8 – Operating Segments

An important use of financial statements is to identify performance and the amount of, and existence of, assets and liabilities. An analysis of the overall picture is required.

The Standard aims to assist analysis of a diverse group's business activities by requiring a breakdown of key figures in the balance sheet and income statement on the same basis as executives use for decision making purposes.

Specialised industries

IAS 26 – Accounting and reporting by retirement benefit plans

Employees (prospective pensioners) and existing pensioners need to know whether a business's pension scheme is adequately funded. The accounts of such funds should clearly and fairly state the basis on which assets and liabilities are recognised and valued in the scheme's balance sheet.

The Standard requires the following disclosures:

- For a defined contributions scheme a statement of the funding policy, a summary of significant accounting policies and net assets available for benefits.
- For defined benefit plans a statement of net assets available for benefits and the actuarial present value of promised retirement benefits and thus the resulting surplus or deficit of the plan's fund.

IAS 41 – Agriculture

Agriculture is a specialised area of business and thus accounting is specialised. An issue is the valuation of livestock and crops.

The Standard requires that a biological asset should be measured on initial recognition and thereafter at its fair value, and appropriate accounting policies should be disclosed.

IFRS 4 – Insurance Contracts

Accounting practices for insurance contracts have been diverse, and have often differed from practices in other sectors. This standard is a first phase aimed at improving accounting for insurance and requiring disclosure of information about such contracts. The approach of this initial standard covering insurance contracts is to align accounting with that set out in the IFRS framework, prohibit what is unacceptable practice and move accounting policies and disclosure towards what is considered best practice.

The three principal aims of the Standards are to:

- Improve accounting policies and ensure they align with the Framework.
- Carry out liability adequacy tests and if there is a shortfall the entire amount should be recognised as a charge in profit and loss.
- Require disclosure about the amount, timing and uncertainty of future cash flows.

IFRS 6 – Exploration for and evaluation of mineral resources

There are differing views as to how exploration and evaluation expenditures should be accounted for. Thus there is the need for a single acceptable approach, consistent with the IFRS framework and other existing IFRS's.

The Standard gives general guidance, permitting capitalisation of expenses associated with exploring and evaluating mineral resources. It permits existing accounting policies to be continued but does point to possibly improved disclosure. It specifically requires that any expenses capitalised as assets should be subject to impairment reviews and gives outline examples of signs of impairment.

Other

IAS 29 – Financial reporting in hyper inflationary economies

Economies can be subject to periods of hyperinflation. The problem is how to meaningfully report business results.

The Standard requires that figures for the period in question should be adjusted as at the year end balance sheet date, either by adjusting the historic cost figures with indices that adjust to the measuring unit (or currency), or by adjusting relevant balance sheet and earnings statement figures to current cost.