Chapter 3: Qualitative characteristics of useful financial information

There are two fundamental qualitative characteristics of financial information

Relevance	Faithful representation
Relevant information is capable of making a difference in the decisions made by the users. It is capable of making difference in decisions if it has predictive value, confirmatory value or both.	Financial reports represent economic phenomena in words and numbers. To be useful it must along with relevance, also represent faithfully, the phenomena which it purports to represent.

Relevance if affected by its

1. Nature and
2. Materiality

To be a faithful representation, information must be

1. Complete
2. Neutral
3. Free from errors
4. Substance over form

Chapter 4: Other areas

1. Underlying assumptions

All these assumptions should be applied when preparing financial statements.

Accrual basis

The effects of transactions and other events are recognized when they occur and reported in the period to which they relate.

Going concern

An entity is considered as going concern if it is expected to continue its current operations in foreseeable future (up to next 12 months). It is assumed that entity has neither the intention nor the need to cut down or reduce its operation.

Income

An income is recognized when an increase in economic benefits from increase in assets or decrease in liabilities has arisen.

Expense

An expense is recognized when a decrease in economic benefits from decrease in assets or increase in liabilities has arisen.

4. Measurement of the elements of financial statements

Measurement

Measurement is the process of determination of monetary amounts at which elements of financial statements are to be recognized in financial statements.

Following measurement basis are used to measure elements of financial statements.

- Historical cost
- Current cost
- Realizable value
- Present value of future cash flows

Historical cost

The fair value of considerations paid to acquire an asset

Current cost

The fair value that will have to be paid if similar asset is acquired currently

Releasable value

Net amount (after deducting selling cost) that can be obtained from selling an asset

Present value

It is value after discounting future cash flows at cost of capital

Accounting estimate

Accounting estimate is the estimate by management about accounting results of an entity. For example estimate about useful life of non-current assets, estimate about residual value of non-current assets and estimate about doubtful debts.
Accounting estimate only changes when some new information becomes available to the management.

- Change in accounting estimates requires prospective adjustment in financial statements of the entity.
- Some accounting estimate changes affect current year only like change in estimate doubtful debts.
- Some accounting estimate changes affect current and future years like change in estimated useful life of the assets or change in estimated residual value of the assets.

Summary

Accounting errors	Retrospective adjustment
Accounting policy	Retrospective adjustment
Accounting estimates	Prospective adjustment

Examples of non adjusting events

- Change of accounting estimates after reporting period
- Fall in fair value of an assets after reporting period
- Destruction or damage of an asset after reporting period
- Revaluation of an asset after reporting period
- Sale or purchase of subsidiary after reporting period
- Major business reorganization after reporting period
- Payment of dividends proposed after reporting period
- Increase or decrease in value of an asset after reporting period

IAS-16

Objective of IAS-16

Objective of IAS-16 is to prescribe the accounting treatment for property plant and equipment in financial statements.

IAS-16 covers

- Definitions
- Recognition
- Measurement
- De-recognition
- Disclosures

Definitions

Property, plant and equipment (PPE) are non-current assets which held for use in trade, manufacture or administration purposes.

Cost

Fair value of considerations paid to acquire an asset.

Fair value

It is the value at which an asset can be exchanged between two knowledgeable willing market participants.

Depreciation

It is the systematic allocation of depreciable amount of an asset to SPL over its useful life.

Carrying amount

It is the cost less accumulated depreciation.

Recognition criteria

PPE should be recognized in SFP if it meets following criteria

1. Cost can be measured reliably and
2. Future economic benefits are probable from use or sale of the asset

Measurement

Initial measurement (at the time of first time recognition)

At the time of initial recognition all property plant and equipment is measured at historical cost.

Finance lease

A lease contract where lessor transfers the right of economic benefits from an asset to the lessee along with risks and rewards related to ownership of the asset.

Its characteristics are

- It is a long term lease.
- Lease term is more than 90% of useful life of the asset.
- PV of minimum lease payments is more than 90% of FV of the asset.
- Risks and rewards related to ownership of the asset are transferred to the lessee.
- Ownership of the asset may pass to the lessee at the end of lease term.
- Asset can be leased out for one time only during its useful life.

Accounting treatments for finance lease

Lessor → Ownership risks and rewards → **Lessee**

Lessee → Lease payment (Principal + Interest) → **Lessor**

Transfer of asset title to lessee

Dr	Lease receivables	x
Cr	NCA	x

With FV of the asset

Receipt of lease installment

Dr	Cash	x
Cr	Lease receivables	x
Cr	Interest income	x

Transfer of asset title from lessor

Dr	NCA	x
Cr	Lease liability	x

With lower of:

1. Fair value of the asset and
2. PV of minimum lease payments

Payment of lease installment

Dr	Lease liability	x
Dr	Interest expense	x

Separation of principal and interest part from total lease payment

Actuarial method is used for separating the interest part and principal part in a total lease installment.

IAS-36

Impairment:

Impairment is the unsystematic decline in value of an asset.

Unsystematic decline means, decline in value which is not related to use of the asset (economic benefits).

Impairment is calculated as:

Carrying amount (NBV)	x
Recoverable amount	(x)

Impairment loss	**X**

Accounting entry of impairment loss is

Dr	SPL (impairment loss)	x
Cr	NCA	x

Recoverable amount

Higher of

NRV | Value in use

Estimated selling price	x
Estimated selling cost	(x)
Estimated cost of completion	(x)
NRV	**X**

Present value (PV) of future net cash flows from use of the asset

Performing impairment test

Impairment test means calculating recoverable amount of an asset and comparing it with carrying amount. If recoverable amount is less than carrying amount it indicates impairment.

Advantages of CCA

- It can be used to indicate whether the dividends paid will reduce the operating capability of the business.
- Assets are valued after management has considered the opportunity cost of holding them. It therefore provides useful guide whether the assets should be held or sold.
- It is relevant to needs of the information users in
  - Assessing the stability of the business entity
  - Assessing liquidity of the business entity
  - Assessing the performance of management
  - Judging future prospectus
- It is easy to use in practice by making simple adjustments to historical cost accounting profits.

Disadvantages of CCA

- It uses judgments in valuation of NRV and value in use.
- It may be problematic in deciding how to provide an estimate of replacement costs for non-current assets.
- Some assets will be valued at current replacement cost and some at NRV or value in use. This may difficult to understand the total value of the assets.
- It can be argued that deprival value is an unrealistic concept because the business entity has not been deprived off the use of the assets.

If performance cannot be measured reliably, then revenue can only be recognized up to the recoverable costs incurred.

If performance obligation is satisfied at a point in time, the revenue is recognized at that time. The point in time is that time at which customer obtains control of the promised asset. Control means ability to get benefits from the asset and preventing others from obtaining benefits from that asset.

Contract costs

Under IFRS-15, following costs must be capitalized

- Directly attributable incremental **costs of obtaining the contract**.
- **Cost of fulfilling the contract** if they do not fall under scope of any other standard and entity expects t recover them.

Capitalized costs of obtaining or fulfilling the contract will be amortized to SPL as revenue is recognized.

Presentation on statement of financial position

If entity has recognized the revenue before considerations are received, it should be recognized

- Either as receivables (if right to receive considerations is unconditional)
- Or as a contract asset

If entity has received considerations before recognition of the revenue, it should be recognized as a contract liability.

Workings

Cost of investment (COI) account (CI %age)

	$	$
Investment in subsidiary	x	--
Share capital	--	x
Share premium	--	x
Pre acquisition reserves	--	x
Pre acquisition adjustments	x	x
Goodwill	--	x (balance)
	--	--
	X	**X**

Note: Goodwill is calculated at the time of acquisition, therefore all the pre-acquisition adjustments (CI %age) are made in this account.

Non controlling interest (NCI) account (NCI %age)

	$	$
Equity capital	--	x
Pre acquisition adjustments	x	x
Post acquisition adjustments	x	x
Goodwill	--	x
c/d balance	x	--
	--	--
	X	**X**

Note: It contains both pre-acquisition and post-acquisition elements, therefore both pre and post acquisition adjustments (NCI %age) are made in this account.

Consolidated reserves (retained earnings) account

	$	$
Parent reserves (100%)	--	x
Subsidiary post acquisition reserves (CI %age)	--	x
Post acquisition adjustments (CI %age)	x	x
Impairment of GW (CI %age)	x	--
Decrease/increase in investment in A	x	x
Balance c/d	x	--
	X	**X**

Subsidiary sold asset to parent

Dr	Consolidated reserves	x	
Dr	NCI	x	
Cr	NCA	x	URP
Dr	NCA	x	Depreciation on URP
Cr	Consolidated reserves	x	

Dividend proposed by the subsidiary

Dr	Dividend proposed	x (In SFP)
Cr	Consolidated reserves	x
Cr	Dividend payable to NCI	x (In current liabilities in consolidated SFP)

Mid-year acquisition

If a subsidiary is acquired during the current year, current year profit of subsidiary should be divided into pre-acquisition and post-acquisition. Profit till acquisition date is pre-acquisition (goes to COI a/c) while after acquisition date is post-acquisition (goes to consolidates reserves a/c).