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**Preface**

If I had to summarize the essence of our mission in five words, I would say it is “building trust in financial markets.” The public interest in our work goes beyond serving the information needs of investors. We protect and strengthen the very fabric of trust in our market economies.

(Hans Hoogervorst, Chairman, International Accounting Standards Board, 2014<sup>1</sup>)

**The Global Accounting Environment**

The role of efficient markets in facilitating continued global economic growth is an economic policy concern of governments around the world. It has been recognized that national differences in accounting standards and lack of transparency in financial reporting impede the efficient allocation of capital—an essential element for economic growth—by adding unnecessary risk and cost to investors. That is why the G20 Leaders, the International Monetary Fund, the World Bank, the Financial Stability Board and IOSCO have expressed their support for the IFRS Foundation’s mission of a single set of high quality global accounting standards (Prada 2014).

The evolution of uniform financial reporting standards has been an inevitable consequence of ever-increasing economic globalization. Recent research conducted by McKinsey & Co. revealed that more than one-third of all financial investments now involve international transactions (McKinsey 2014). It concluded that the total volume of global flows could triple in the next decade, powered by a combination of rising prosperity, the participation of the emerging world, and technological progress. Given these inexorable trends, financial information that is relevant, reliable and comparable is needed to permit the efficient allocation of capital, and for increased trust and confidence in capital markets.

The IFRS Foundation’s primary mission is to develop a single set of high quality, understandable, enforceable and globally accepted International Financial Reporting Standards (IFRS), based upon a clearly articulated, coherent set of foundational principles. Although a single, global language of financial reporting is now widely supported around the world, the controversy has come in determining what that single, global set of standards should be. This has been significantly complicated by differences in business and financial cultures among countries, as well as in accounting and auditing traditions and regulatory environments.

**Progress toward Global Standards**

IFRS has been widely accepted around the world and has unquestionably improved international financial reporting transparency and comparability, impacting both the amounts and patterns of

capital investments. Employment of uniform financial reporting standards has both reduced the accounting costs incurred by reporting companies and lowered their costs of capital. All of these effects contribute to the wealth of investors, nations, and society as a whole.

A decade ago, on 1 January 2005, the then-25 European Union (EU) Member States made a coordinated move to IFRS from their varying and often incompatible sets of national accounting standards. Other countries, including Australia, New Zealand, Hong Kong and South Africa soon followed with their own transitions to IFRS. Thus, over the last decade, IFRS has become the predominant financial reporting scheme employed by most global industry sectors. According to the IFRS Foundation's most recent analysis, 114 of the 138 countries studied require the use of IFRS for all or most public companies (Prada 2014; Pacter 2014).

Nevertheless, a number of other countries, including such major economies as China, India, Japan and the United States, although making significant progress towards converging with global standards, have not yet fully transitioned to IFRS. Despite many years of the FASB's involvement with several major joint projects with the IASB—a number of which have been brought to successful conclusions—the U.S. remains one of few important countries not requiring or even permitting use of IFRS for financial reporting by its domestic public firms. On the other hand, since November 2007 the U.S. Securities and Exchange Commission (SEC) has permitted the use of IFRS, as issued by the IASB, by foreign registrants for their U.S. listings, if they use IFRS for reporting in their home country (SEC 2007).

### Consistent Application of Global Standards

Accounting standards have always evolved over time, in response to changes in the economies and in the business and regulatory environments of the nations employing those standards. IFRS has similarly exhibited a pattern of continual improvement and change since the inception of this international development effort in 1973. In the wake of the recent financial crisis, a number of new or improved standards have been issued, such as those on fair value measurements, consolidated financial statements and financial instruments. Recently, a new converged (with U.S. GAAP) standard on revenue recognition from contracts with customers was promulgated. Other important projects are still in progress, including those addressing leasing, insurance, and financial disclosures, as well as a review of the *Conceptual Framework*. However, Ian Mackintosh, IASB Vice-Chairman, predicts that after a decade of frenetic change in financial reporting around the world, a period of relative calm may be enjoyed, as “IFRS matures” (Mackintosh 2014).

As the body setting IFRS has become established, its priorities have evolved. Following a decade of convergence projects conducted principally with the FASB, the IASB has moved toward a more multilateral approach, engaging with standard-setters around the world, with the establishment of the Accounting Standards Advisory Forum (ASAF). Its central focus now is on seeking to encourage greater consistency in the application of IFRS internationally. For example, the jurisdictional profiles published on the IFRS website ([www.ifrs.org](http://www.ifrs.org)) reveal that some jurisdictions have modified IFRS as a temporary step to aid the transition to global standards, thus introducing anomalies and inconsistencies in the application of IFRS. Indeed, the consistency of IFRS application can vary even within a single jurisdiction, such as EU (Amiraslani et al. 2013). It is therefore seen as important that standard setters, regulators and accounting firms work to improve consistency in the implementation and application of global standards.

The U.S. SEC is still considering whether to require or permit IFRS in the U.S., and it is uncertain whether this will be resolved in the near term. There is consequently a growing recognition that if U.S. companies will not be required to use IFRS, the globalized business environment will compel accounting professionals to become “bilingual” in both U.S. GAAP and IFRS. This book addresses the IFRS aspect of this perceived need for bilingualism, as well as key differences between IFRS and U.S. GAAP.

The present work focuses on learning IFRS by understanding the *Conceptual Framework for Financial Reporting (Conceptual Framework)*. Chapters begin by linking broad concepts to general

principles, and then to the specific requirements of each IFRS. This approach will help students develop and understand the judgments required using principles-based standards, rather than the memorization approach commonly applied with rules-based standards. Accordingly, this textbook employs a three-step progression to teaching IFRS judgments; from concepts to principles/rules to the judgments required in the application of those rules.

Guided by the perceived need in university, preparer, user, and public accounting education, this text features a clear presentation of the concepts underlying IFRS, detailed illustrations, explanations, and applications. In addition, the inclusion of “real-world” examples and case studies links accounting theory to the practical accounting environment.

Each chapter begins with the fundamental concepts and the reasons why they are important. Each standard is explicitly connected to the *Conceptual Framework* by clearly stated objectives and principles. Chapters provide the requirements of each standard, develop the student's understanding of these requirements through the use of examples, indicate the significant judgments that are required in applying the standard, and contain a comparison of IFRS to U.S. GAAP. Because IFRS are subject to continuing improvement, we include a Future Developments section at the end of some chapters, explaining salient current issues on the IASB's active agenda, their respective stages of development, and the expected outcomes. Chapters on financial instruments and revenue from contracts with customers are based on newly issued standards, for which early adoption is permitted.

### Suggestions for Instructors

The book provides comprehensive coverage of important IFRS with significant instructional flexibility. The book is designed to be used either in a one-term course that provides an overview of the IASB due process, the *Conceptual Framework*, and the core accounting topics, or in a two-term course allowing for complete coverage of the standards and interpretations. The book is also designed to be used for continuing professional education (CPE) courses or for self-study. The self-contained units of subject matter allow for substantial flexibility in sequencing the course materials and in the time devoted to each topic. In addition, individual chapters are organized to allow for opportunities to go into greater depth on particular topics through the use of case studies.

This book should be helpful to students in both the U.S. and abroad, as well as financial statement users and preparers. English-language texts and other books are used in many nations, and this book should therefore be appealing to academic and accounting professionals in many countries. The is ideal for upper division undergraduate students and master's degree students, but could also benefit practicing accountants, financial executives, investment managers, and accounting educators who want to develop their own understanding of IFRS.

### Book's Companion Website

At the book's companion website, students can also access the following resources:

- Extensive end-of-chapter assignments (including ‘Applying the *Conceptual Framework*’ section).
- PowerPoint presentations
- Research cases
- Appendixes to the chapters to keep this book the most up-to-date
- A complete *Glossary* of all the key terms used in the text, in alphabetical order.

Extensive end-of-chapter assignments provide the opportunity for students to increase their understanding of the chapter material and for instructors to assess mastery of the subject matter. End-of-chapter materials expose students to other pillars of high quality financial reporting, including

international auditing standards, international ethics standards, corporate governance and enforcement. Additionally, the end-of-chapter materials include emerging financial reporting issues such as the concept of integrated reporting, sustainability and social responsibility accounting.

The end-of-chapter materials progress from simple focused questions and exercises to more complex integrated problems and cases. Cases provide opportunities for gaining exposure to different interpretations and applications of IFRS as well as the effects of IFRS adoption on financial statements. Also included are a number of useful Internet links related to subject matter to expand expertise in analyzing real-world financial reporting in accordance with IFRS. Research assignments as well as task-based simulations require students to search for and reference relevant IFRS (a skill expected to be tested on future CPA examinations).

Instructor supplementary materials include: Solutions Manual to end-of-chapter assignments, Test Bank, Companion Websites, Videos, and PowerPoint Presentations.

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### Note

1 Hans Hoogervorst, Chairman, International Accounting Standards Board, Building Trust in Financial Markets. Sydney, 10 April 2014.

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## Presentation of Financial Statements (IAS 1)

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### Learning Objectives

To understand:

- Objectives of financial statements
- Components of a complete set of financial statements
- Requirements for fair presentation and compliance with IFRS
- Assessment of an entity's ability to continue as a going concern
- Structure and content of financial statements
- Structure and content of the notes to financial statements
- Significant judgments required in presenting financial statements.

### Introduction of Accounting

This chapter focuses on IAS 1, *Presentation of Financial Statements*. The general requirements for the presentation of financial statements set out in this standard are designed to improve the usefulness of information reported in an entity's financial statements and to help users make decisions about providing resources to the entity.

The objective of financial statement presentation is consistent with the overall objective of general purpose financial reporting provided in the *Conceptual Framework*. Financial statement presentation focuses on providing information about an entity's financial position and about an entity's changes in financial position that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

The overall requirements for the presentation of financial statements are prescribed in IAS 1; however, the fundamental concepts of defining the reporting entity, the qualitative characteristics of useful financial information, and the elements of financial statements are described in the *Conceptual Framework* (discussed in Chapter 2). Other IFRS provide recognition, measurement, and disclosure requirements for different transactions and events. IAS 7, 10, 24, 33, and IFRS 5 and 8 provide additional guidance on the presentation of financial statements.

### Why Is Presentation Important?

The requirements for presentation of financial statements directly affect how the management of an entity communicates financial statement information to those who provide resources to the entity and their investment choices, with consequences for aggregate economic activity. This information helps existing and potential investors, lenders, and other creditors assess the amount, timing, and uncertainty of future cash flows and make better decisions in their capacity as capital providers.

Information presented in the financial statements should be separated into sections and categories. For example, an entity separately presents information about its operating, investing, and financing activities and separates its discontinued operations from its continuing activities. Also, aligning line items, their descriptions, and the order in which information is presented across the financial statements helps users understand relationships between items across financial statements.

Thus, the financial statements should complement and relate to each other, showing a cohesive financial picture of an entity's activities. As a result, a user can understand the flow of information through the various financial statements. For example, a user should be able to compare operating income with operating cash flows in determining earnings quality. This separation and organization of information increases the transparency of the information provided and helps users understand an entity's financial position and changes in its financial position during a period.

Grouping (aggregating) financial statement items on the basis of shared characteristics and how they respond to economic events helps in predicting future cash flows, which is a fundamental objective of financial reporting. Consequently, IAS 1 requires that changes in equity arising from transactions with owners are presented in the statement of changes in equity, separately from non-owner changes in equity that are presented in the statement of profit or loss and other comprehensive income.

Based on information presented in an entity's financial statements, users should be able to assess the entity's liquidity, the entity's ability to meet its financial commitments as they become due, and the entity's financial flexibility, such as the entity's ability to earn returns on investments, fund future growth, and respond to unexpected needs and opportunities.<sup>1</sup>

### Key Terms Defined

**General-purpose financial statements.** The financial statements, comprising the statement of financial position, the statement(s) of profit or loss and other comprehensive income, the separate

income statement (if presented), the statement of changes in equity, and the statement of cash flows, that are intended for users who cannot require an entity to prepare reports tailored to their particular information needs.

**Impracticable.** When an entity has made every reasonable effort to apply a requirement but is unable to do so.

**International Financial Reporting Standards (IFRS).** Standards and Interpretations issued by the International Accounting Standards Board (IASB) that comprise:

1. International Financial Reporting Standards (IFRS);
2. International Accounting Standards (IAS);
3. IFRIC Interpretations; and
4. SIC Interpretations.

**Material omissions or misstatements.** Omissions and misstatements of amounts in the financial statements that would, individually or collectively, influence the economic decisions of a user. Materiality is determined based on the size and nature of the omission or misstatement. Both qualitative and quantitative aspects are considered when judged by the surrounding circumstances.

**Notes.** All information provided in addition to that information presented in the financial statements. The notes to the financial statements include narrative descriptions or disaggregation of items presented in the statements as well as information about items that do not qualify for recognition in the statements but are disclosed as required by IFRS.

**Other comprehensive income.** Elements of income and expense (including reclassification adjustments) that are not recognized in profit or loss as required or permitted by other IFRS.

**Owners.** Holders of equity instruments.

**Profit or loss.** The total income less expenses, excluding the amounts included in other comprehensive income.

**Reclassification (also called "recycling") adjustments.** Amounts that were previously recognized in other comprehensive income that have been reclassified to profit or loss in the current period.

**Total comprehensive income.** The change in equity during a period as a result of transactions and other events, other than those changes from transactions with owners acting in their capacity as owners. It comprises all items presented in the statement of profit or loss and other comprehensive income.

(Source: IAS 1.7)

## IAS 1, PRESENTATION OF FINANCIAL STATEMENTS

### Objective and Scope

This Standard sets out the overall requirements for the presentation of general purpose financial statements, their structure, and minimum requirements for content. The objective of such requirements is to enhance comparability of the entity's financial statements across periods and with those of other entities.

IAS 1 applies to all general purpose financial statements prepared and presented in accordance with IFRS. IAS 1 is not applicable to summarized (condensed) financial statements that an entity prepares under IAS 34. However, for year-end financial statements, IAS 1 applies regardless of whether

the entity presents consolidated financial statements under IFRS 10, or separate financial statements under IAS 27 (IAS 1.4). Additional guidance on the presentation of financial statements is provided in IAS 7, 10, 24, 33, and IFRS 5 and 8.

### Executive Summary

- An entity whose financial statements comply with all the requirements in IFRS is required to make an explicit and unreserved statement of such compliance in the notes.
- A complete set of financial statements includes the statement of financial position, the statement of profit or loss (PL) and other comprehensive income (OCI), the statement of changes in equity, the statement of cash flows, and the accompanying notes to the financial statements.
- A minimum presentation of certain asset, liability, and equity accounts in the statement of financial position is prescribed in IAS 1. Additional line items are presented when the size, nature, or function of an item is relevant to understanding an entity's financial position.
- The sequence or format in which items are to be presented is not prescribed and may vary according to the nature of the entity and its transactions.
- A classified statement of financial position is required, except when liquidity presentation provides reliable and more relevant information.
- Total comprehensive income is presented in one statement of PL and OCI (also called the statement of comprehensive income) or in two statements comprising a separate PL statement and a separate statement of OCI.
- Expenses are classified based on either the *nature* or the *function* of the expense within the entity. If functional presentation is used, specific disclosures in the notes are required about the nature of expenses.
- Income or expense items may *not* be presented or described as "extraordinary items" in the statement of PL and OCI, in the separate statement of PL (if presented), or in the notes.
- Changes in equity result from an entity's total comprehensive income for the period, the effects of changes in accounting policies, and corrections of errors recognized in the period. Additional changes in equity arise because of the amounts of contributions from, and other distributions to, owners during the period.
- Financial statements are prepared on an accrual basis except for the statement of cash flows.
- Comparative information for all amounts reported in the financial statements (at least a two-year presentation) is required.
- Disclosures must be made concerning significant judgments (except for judgments involving estimations) that are required in presenting financial statements, including judgments in assessing materiality and the going concern assumption.

### Financial Statements

#### Purpose

The objective of financial statements is to provide useful information to a wide range of users. Useful information aids users of the financial statements in making economic decisions based on the financial position, cash flows, and financial performance of the entity (IAS 1.9). Because this information is communicated through a complete set of financial statements, the standard specifically defines what is meant by a complete set of financial statements.

#### Complete Set of Financial Statements

IAS 1 specifies the components of a complete set of financial statements and establishes criteria for the identification and separation of those components from other information presented. Illustration 4.1 presents six components of a complete set of financial statements.

### Illustration 4.1 A Complete Set of Financial Statements

Components of a complete set of financial statements include:

1. A statement of financial position at the end of the reporting period
2. A statement of profit or loss and other comprehensive income for the period
3. A statement of changes in equity for the period
4. A statement of cash flows for the period
5. Notes comprising a summary of significant accounting policies and other explanatory information
6. A statement of financial position at the beginning of the earliest comparative period presented when an entity applies an accounting policy retrospectively, makes a retrospective restatement, or reclassifies items within the financial statements

(Source: IAS 1.10)

The titles presented in Illustration 4.1 are not mandatory and an entity may choose to use other titles in its financial report. For example, in some jurisdictions the statement of financial position is commonly referred to as a balance sheet and the statement of PL and OCI is referred to as a statement of comprehensive income. The latter statement has also been called the statement of recognized income and expense.

An entity may present a single statement of PL and OCI, or it may present a separate statement of PL followed by the statement presenting other comprehensive income (that begins with PL and presents OCI items). All financial statements included in a complete set of financial statements are presented with equal prominence.

### General Considerations

#### Fair Presentation and Compliance with IFRS

It is presumed that financial statements fairly present the financial position, financial performance, and cash flows of an entity. Fair presentation means that transactions, other events and conditions are faithfully represented according to the definitions and recognition criteria established by the *Conceptual Framework*. An entity's financial statements in accordance with IFRS, accompanied by additional disclosures when needed, are presumed to achieve fair presentation (IAS 1.15).

An entity is required to make an *explicit and unreserved statement of compliance with IFRS* in the notes. Financial statements are in compliance with IFRS only if they comply with *all* of the requirements in IFRS. In virtually all circumstances, applying IFRS should result in financial statements that achieve a fair presentation. However, in *extremely rare circumstances*, when management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements as set out in the *Conceptual Framework*, the entity can depart from that requirement if the relevant regulatory framework does not prohibit such a departure.<sup>2</sup> This departure is referred to as a "true and fair override" in some jurisdictions. In such circumstances, the entity is required to disclose the title of the IFRS and the related requirement from which the entity has departed, the nature of the departure, and the reason why the IFRS treatment would be so misleading that applying the standard would conflict with the objectives of financial statements as set out in the *Conceptual Framework*. In addition, the standard requires disclosure of the financial impact on each financial statement item affected by the departure from IFRS.

#### Illustration 4.2 Société Générale: Applying “True and Fair Override”

It is not often that a major international bank admits it is violating well-established accounting rules, but that is what Société Générale has done in accounting for the fraud that caused the bank to lose 6.4 billion euros—now worth about \$9.7 billion—in January.

In its financial statements for 2007, the French bank takes the loss in that year, offsetting it against 1.5 billion euros in profit that it says was earned by a trader, Jérôme Kerviel, who concealed from management the fact he was making huge bets in financial futures markets.

In moving the loss from 2008—when it actually occurred—to 2007, Société Générale has created a furor in accounting circles and raised questions about whether international accounting standards can be consistently applied in the many countries around the world that are converting to the standards.

In its annual report released this week, Société Générale invoked what is known as the “true and fair” provision of international accounting standards, which provides that “in the extremely rare circumstances in which management concludes that compliance” with the rules “would be so misleading that it would conflict with the objective of financial statements,” a company can depart from the rules.

In its annual report, Société Générale says that applying two accounting rules—IAS 10, “Events After the Balance Sheet Date,” and IAS 39, “Financial Instruments: Recognition and Measurement”—would have been inconsistent with a fair presentation of its results. But it does not go into detail as to why it believes that to be the case (*The New York Times*, March 7, 2008).

Note that using the “fairness override” is difficult to justify. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity’s compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements as set out in the *Conceptual Framework*. Any departure from the standard would thus probably not be warranted under such conditions. Also, regulations in many jurisdictions, such as stock market rules, prohibit departure from IFRS accounting requirements under any circumstances.

#### Going Concern

A key assessment that management makes when preparing financial statements is whether an entity will continue as a going concern. An entity is considered a going concern if the entity appears to be able to continue its normal operations. If an entity’s economic position is such that management plans to discontinue business activities or liquidate a majority of the entity’s assets, or there is no feasible option to do otherwise, the entity is *not* considered a going concern (IAS 1.25). When assessing whether the going concern assumption is appropriate, management should consider all available information about the future.

In some cases there may be few uncertainties regarding the going concern status of an entity. For example, when the entity has a history of profitable operations and is not subject to business and financial risks, the entity is a going concern. On the other hand, when management is committed to a plan to liquidate the entity or to cease operations, the entity is *not* a going concern. In less clear cases, significant judgment may be required of both managers and auditors to evaluate whether an entity has the ability to continue as a going concern.

Management needs to weigh current and expected profitability, debt repayment schedules, and potential sources of replacement financing before deciding that the going concern status is appropriate. For example, during a financial crisis, an entity’s general lack of ability to find reasonable financing can place doubts on the entity’s ability to continue as a going concern. When evaluating whether

an entity has a going concern issue, The International Auditing and Assurance Standards Board (IAASB) Staff Audit Practice Alert, *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, directs auditors to consider fixed-term borrowings near maturity without any realistic prospects for renewal or repayment, excessive reliance on short-term borrowings to finance long-term assets, indications of withdrawal of support by creditors, an inability to comply with terms of loan agreements, and the loss of a major market, supplier, or franchise<sup>3</sup> (Hodgdon et al. 2011).

#### Illustration 4.3 Excerpts from the Austrian Airlines 2008 Group Annual Report: Basis of Preparation (Going Concern Principle)

“... For the above mentioned reasons, the Board of Management assumed a sufficient availability of equity and a positive going concern prognosis in preparing the consolidated financial statements for the 2008 financial year.

In the event of a negative decision on the part of the European Commission or a decision after 31.7.2009, the Board of Management will not be able to assume the continuing existence of the company, which is why there are major uncertainties in respect to the going concern principle. Any departure from the going concern premise would have a significant impact on the assets, financial position, and profit and loss of the Austrian Airlines Group.”

When there are material uncertainties related to the going concern status of an entity, the entity is required to disclose those uncertainties. Moreover, if an entity is not a going concern, it must disclose that fact, the reason why it is not a going concern, as well as the basis on which it prepared the financial statements.

A going concern basis is fundamental to many accounting principles. For example, this assumption provides justification for measuring certain financial statement items at amortized cost. If there are doubts about an entity’s ability to continue as a going concern, management is required to conduct impairment tests of the entity’s assets. When an entity is no longer a going concern, assets would be measured at fair value less costs to sell because those assets can no longer be considered to have value in use.

If the result of the assessment casts significant doubt upon the entity’s ability to continue as a going concern, management is required to disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

#### Example 4.1 Going Concern

In anticipation of the Clean Energy and Security Act of 2009 (Cap and Trade System), Sun Power Entity (SPE) was established in 2007 to produce solar panels (PV) to meet the increasing demand for low carbon generation in the U.S. SPE was profitable during its first three years. In 2011, an increasing supply of low-cost solar panels from China reduced the competitiveness of SPE’s products and resulted in SPE reporting substantial operating losses. In response, the solar industry and its labor union lobbied government to impose tariffs on solar panels. On December 10, 2011, the government announced that it would impose limited solar panel tariffs in 2012. As a result, SPE’s management expects that this will help SPE return to profitability in 2012.

Based on management’s assessment on December 31, 2011, the financial statements of SPE have been prepared on the going concern basis. However, management must disclose all facts and the reason why the entity is regarded as a going concern.

### Accrual Basis of Accounting

Financial statements, except for cash flow information, are prepared using accrual accounting (IAS 1.27). Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those transactions occur, not necessarily when the resulting cash receipts and payments occur. Consequently, an entity using the accrual basis of accounting recognizes the elements of financial statements (assets, liabilities, equity, income, and expenses) when they satisfy the definitions and recognition criteria for those elements in the *Conceptual Framework* (IAS 1.28).

Information about an entity's financial performance during a period, as reflected by changes in its economic resources and claims (except those provided by investors and creditors) should be useful in assessing the entity's ability to generate net cash inflows. Without the accrual basis of accounting, management could have significant discretion in determining profit for the period and, for example, be tempted to smooth earnings (Wells, 2011).

### Materiality and Aggregation

In accordance with IAS 1, when a grouping of similar items is material, an entity should present them separately from other classes of items (IAS 1.29). Therefore, each material class of assets, liabilities, equity, income, and expenses that have similar nature or function is aggregated and presented as a separate line item in the financial statements. For example, an entity will have various classes of fixed assets ranging from buildings to machinery. These assets would be grouped together in one line item (commonly named Property, Plant, and Equipment) in the financial statements. A line item that is not individually material is aggregated with other items either in those statements or in the notes. Dissimilar items are presented separately unless they are immaterial. Materiality is assessed from the users' perspective; accordingly, information is considered to be material if "omitting it or misstating could influence decisions that users make on the basis of financial information about a specific reporting entity" (*Conceptual Framework*, QC11). Because financial accounts are highly summarized, materiality facilitates aggregation of information (e.g., total revenue representing retail revenues and wholesale revenues) without including irrelevant detail (but only if such presentation will enhance the usefulness of such information in predicting future cash flows).

#### Example 4.2 Materiality of Prior Errors

In 20X5, before the entity's 20X4 financial statements were approved for issue, Progress Entity (PE) discovered a systematic error in the calculation of its development expense. Further investigation revealed that the calculation was incorrect beginning with 20X0, the year when PE was established. The cumulative effect of this error on PE's retained earnings is \$200,000. PE reported retained earnings of \$500,000.

This error is material because it is large enough to influence the economic decisions that users make on the basis of the financial statements.

Judgment is required to determine if the prior-period error is material and to differentiate the correction of prior-period errors from changes in accounting policies and changes in accounting estimates. Because immaterial prior-period errors are not expected to influence users' decisions made on the basis of the financial statements, such errors may not need to be corrected or may be corrected prospectively, as opposed to retrospective restatement of material errors. When assessing whether the error is material, its effect on trends (particularly trends in profitability) must be considered.

Also, a current-year immaterial error may have a material impact in future periods because of a cumulative effect.

### Offsetting

An entity should *not* offset (i.e., present as a single *net* amount in the statement of financial position) assets and liabilities or income and expenses, unless required or allowed by an IFRS (IAS 1.32). According to IAS 1, offsetting (netting) generally obscures the existence of some financial assets and financial liabilities in the statement of financial position. Therefore, presenting assets and liabilities at net amounts may limit the ability of users of financial statements to assess the entity's financial strengths and weaknesses. However, measuring assets net of valuation allowances, such as presenting inventories net of obsolescence allowances, receivables net of doubtful debts allowances, or property, plant, and equipment net of accumulated depreciation, is not considered offsetting.

### Frequency of Reporting

IAS 1 requires an entity to prepare and present at least annually a complete set of comparative financial statements (IAS 1.36). When the end of the reporting period changes, necessitating financial statement presentation for a period longer or shorter than one year, the reason for using a different period and lack of full comparability with previous period must be disclosed.

### Comparative Information

An entity is required to present at least two statements of financial position as of: (a) the end of the current period, and (b) the end of the previous period (which is the same as the beginning of the current period). Also, a third statement as of the beginning of the earliest comparative period presented is required whenever there has been a retrospective application, retrospective restatement, or reclassification of items in the financial statements (IAS 1.39).

Presentation and classification of items in the financial statements should be consistent from one period to the next unless following a significant change in the nature of the entity's operations makes another presentation or classification more appropriate (using the criteria of IAS 8), or when an IFRS requires a change in presentation.

When there is a change in the presentation or classification of items in the financial statements, the comparative information is also reclassified, unless it is impractical. When comparative amounts are reclassified, or if it is impracticable to reclassify them, adequate disclosures are provided.

### Structure and Content

#### Identification of Financial Statements

An entity is responsible to clearly identify the financial statements and notes to ensure that the users can clearly distinguish them from other information that may be included with the published financial reports. To help distinguish the financial statements and notes, the following information is displayed prominently: (a) the name of the reporting entity; (b) whether the financial statements are consolidated; (c) the date of the end of the reporting period or the period covered; (d) the presentation currency; and (e) the level of rounding, e.g., in millions (IAS 1.51).

#### Statement of Financial Position

##### Information to Be Presented

The elements of financial statements directly relate to the measurement of financial position are assets, liabilities, and equity. These elements are defined in the *Conceptual Framework* as follows:



- An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- Equity is the residual interest in the assets of the entity after deducting all its liabilities (*Conceptual Framework, 4.4*)

IAS 1 specifically requires that financial statements contain certain line items. IAS 1 also outlines how to distinguish current assets from non-current assets and current liabilities from non-current liabilities. The recognition and measurement of assets, liabilities, and equity items are determined by other IFRS.

Illustration 4.4 shows the items that, as a minimum, are presented separately in the statement of financial position (IAS 1.54).

#### Illustration 4.4 Minimum Line Items in the Statement of Financial Position

- Property, plant, and equipment;
- Investment property;
- Intangible assets;
- Financial assets (excluding amounts shown under (e), (h) and (i));
- Investments accounted for using the equity method;
- Biological assets;
- Inventories;
- Trade and other receivables;
- Cash and cash equivalents;
- The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5;
- Trade and other payables;
- Provisions;
- Financial liabilities;
- Liabilities and assets for current tax (IAS 12);
- Deferred tax liabilities and deferred tax assets (IAS 12);
- Liabilities included in disposal groups classified as held for sale in accordance with IFRS 5;
- Non-controlling interests, presented within equity; and
- Issued capital and reserves attributable to owners of the parent.

(Source: IAS 1.54)

An entity is required to present additional line items, headings, and subtotals if such presentation is relevant and would help users to understand the entity's financial position. Management must use judgment when assessing whether additional items should be presented based on: (a) the nature and liquidity of assets; (b) the function of assets within the entity; and (c) the nature, timing, and amount of liabilities (IAS 1.58). In general, using different measurement bases would require separate presentation.

#### Current Assets

The usefulness of the statement of financial position is enhanced when assets and liabilities are classified as current and non-current. For instance, many investors and creditors rely on the current/non-current classification when assessing the liquidity of the entity. However, there are some

circumstances when a presentation based on level of liquidity provides more reliable and more relevant information. In these circumstances, all assets and liabilities are presented in order of liquidity.

An entity classifies assets as *current* assets when (IAS 1.66):

- The entity expects to realize or use the asset in its normal operating cycle;
- The entity holds the asset primarily for trading purposes;
- The entity expects to realize the asset within one year after the reporting period; or
- The asset is cash or a cash equivalent (as defined in IAS 7). The exception is when the cash (or cash equivalent) has been designated or restricted in such a way that the cash cannot be exchanged or used to pay off debt or settle other liabilities during the subsequent reporting period.

All other assets are classified as non-current assets.

Current assets include cash, receivables, inventory, prepayments, some financial assets that meet the definition of held-for-trading in IFRS 9, and the current portion of non-current financial assets. Inventory and trade receivables that are sold, consumed, or realized during the normal operating cycle are classified as current even if they are not expected to be realized within twelve months after the reporting period. Other non-cash assets that are not part of an entity's normal operating cycle would have to be realized within 12 months after the end of the reporting period to be classified as current.

IAS 1 states that the operating cycle is the period during which an entity acquires assets, processes the assets, and then realizes the assets (generally through sale) for cash or cash equivalents (IAS 1.68). For example, if an entity converts raw materials into finished goods during an 8-month production process, keeps inventory of 2 months raw materials and 2 months finished goods, and it converts receivables into cash 3 months after the date of sale, the entity's operating cycle is 15 months (8 + 2 + 2 + 3). When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. A long operating cycle is unavoidable in certain industries. For example, wineries and distilleries keep inventory on hand for years before it is sold.

#### Example 4.3 Current/Non-Current Asset

Global Entity (GE) operates a tropical mango tree plantation in India. Mango trees bear fruit over many years.

In accordance with IAS 41, *Agriculture*, the mango trees and mango fruits are accounted for as a single biological asset that is classified as a non-current asset until the point of harvest. After harvest, the mango fruits are classified as current assets.

#### Current Liabilities

An entity classifies liabilities as *current* liabilities when (IAS 1.69):

- The entity believes the liability will be settled within the normal operating cycle period;
- The entity holds the liability primarily for the purpose of trading;
- The obligation to settle the liability must be fulfilled within a year of the end of the reporting period; or
- The entity cannot defer settlement of the liability past the end of the subsequent reporting period.

All other liabilities should be classified as non-current.

Current liabilities that are part of the working capital used in the entity's normal operating cycle, such as trade payables and some accruals (e.g., for employee and operating expenses), are classified as current even if they are due to be settled more than 12 months after the reporting period. Other liabilities such as certain financial liabilities, the current portion of non-current financial liabilities, and bank overdrafts that should be settled within 12 months after the reporting period are also classified as current, even though they are not part of the working capital. In general, an entity can control its use of current assets but is limited by its contractual obligations regarding current liabilities.

Financial liabilities are classified as current even if (a) the initial term of the liability was for a period exceeding twelve months and (b) the entity reaches an agreement to change the settlement of the liability (through refinancing or rescheduling payments) after the end of the reporting period but before it issues the financial statements (IAS 1.72). However, an entity would classify the liability as non-current if the lender agreed before the end of the reporting period to give the entity an unconditional right to defer the settlement of the liability for at least 12 months from the end of the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its current/non-current classification.

#### Example 4.4 Current/Non-Current Liability

Frontier Entity (FE) has a long-term loan that is due this year. However, FE expects to refinance or roll over this obligation for at least 12 months after the reporting period. Although at the end of the current reporting period FE does not have an unconditional right to refinance the loan, FE should have all arrangements for refinancing completed before the financial statements are authorized for issue.

The loan is classified as a current liability because at the end of the reporting period FE does not have an unconditional right to defer the settlement of the liability for at least 12 months from the end of the reporting period. If at the end of the reporting period it is at the FE's discretion whether to refinance the loan, the loan would be classified as non-current.

#### Information to Be Presented in the Statement of Financial Position or in the Notes

An entity discloses, in the statement of financial position or in the notes, further subclassifications of the line items based on the requirements of IFRS and the size, nature, and function of the amounts involved. Preparers use judgment to determine the subclassifications that are appropriate for the entity's operations. Examples of such subclassifications (separate classes) of line items are as follows:

- Trade and other receivables: trade receivables, receivables from related parties, accrued income (not yet billed), prepaid expenses;
- Inventory: merchandise, raw materials, work in progress, finished goods;
- Property, plant, and equipment: land and buildings, aircraft, machinery, motor vehicles, office equipment.

Equity capital and reserves are disaggregated into paid-in capital, share premium, and reserves. Additionally, entities with share capital are required to disclose the following information (IAS 1.79):

- Numbers of shares authorized, issued and fully paid, and issued but not fully paid;
- Par value per share (or that the shares have no par value);

- Reconciliation of the number of shares outstanding at the beginning and at the end of the period;
- Description of rights, preferences, and restrictions for each class;
- Shares in the entity held by the entity or by its subsidiaries or associates;
- Shares reserved for issue under options and contracts; and
- Description of the nature and purpose of each reserve.

Entities without share capital, such as partnerships or trusts, are required to disclose information equivalent to that presented by entities with share capital, reporting changes in and information about each category of equity. Certain reclassifications between financial liabilities and equity also have to be disclosed.

#### Statement of Profit or Loss and Other Comprehensive Income

IAS 1 specifies requirements for presenting an entity's financial performance for the period. The elements of financial statements directly related to measuring P&L are defined in the *Conceptual Framework* (*Conceptual Framework*, 4.29–4.35) as follows:

- Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets, or in the form of decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets, or in the form of incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The definition of income encompasses both revenues and gains, while the definition of expenses encompasses losses as well as those expenses arising in the course of the entity's ordinary activities. IAS 1 also introduced items of OCI that are recognized outside of PL. Many investors and creditors consider PL (also called net income) to be a critical measure for predicting future cash-generating ability of an entity. Additionally, other measures that are based on PL, such as return on assets, return on equity, return on sales, and earnings per share are vital in financial statement analysis.

IAS 1 defines total comprehensive income as "the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners" (IAS 1.7). It includes all components of PL and of OCI.

#### Accounting Policy Choice

An entity can choose to present total comprehensive income for a period either:

- In a single (one) statement, reporting all items of income and expense recognized in a period, unless an IFRS requires otherwise; or
- In two statements, separately presenting (1) a statement of PL and (2) a statement beginning with PL and listing all OCI items.

The accounting policy choice an entity selects are applied consistently from period to period. A change from the single-statement approach to the two-statement approach, or vice versa, is a change in accounting policy accounted for in accordance with IAS 8.

In addition, an entity can present expenses using a classification based on either the nature of expenses or the function of expenses within the entity, whichever provides reliable and more relevant information to users of the financial statements.

**Profit or Loss (PL)**

An entity is required to report information about specific line items in presenting PL. These specific line items include:

- Revenue, showing separately interest revenue calculated using the effective interest method;
- Gains and losses arising from the derecognition of financial assets measured at amortized cost;
- Finance costs;
- Impairment losses (including reversals of impairment losses or gains) under IFRS 9;
- Share of the profit or loss of associates and joint ventures accounted for using the equity method;
- Gain or loss on reclassification of a financial asset out of the amortized cost to FVPL representing a difference between the previous amortized cost and its fair value at the reclassification date (as defined in IFRS 9);
- Any cumulative gain or loss previously recognized in OCI on reclassification of a financial asset out of FVOCI to FVPL measurement category;
- Tax expense; and
- A single amount for the total of discontinued operations under IFRS 5 (IAS 1.82).

When presenting separate line items in PL, consideration should be given to materiality of income and expense items, the frequency of the line items, and their usefulness in predicting future net cash flows. An entity aggregates items based on their nature. *Other income and expenses* report incidental items of income and expenses not related to the primary operating activities of the entity (e.g., incidental rental income from equipment not currently used in operations).

Also, an entity allocates and presents on the face of the statement the amount of PL and, separately, total comprehensive income, that is attributable to:

- Non-controlling interests; and
- Owners of the parent.

An entity presents all items of income and expense in the statement of PL and OCI unless an IFRS requires or permits otherwise. For example, in accordance with IAS 8 the effect of changes in accounting policies and the correction of errors are recognized outside PL in the current period.

**Other Comprehensive Income (OCI)**

Certain items that arise during a period are classified as OCI. Commonly reported OCI items include:

- Changes in the revaluation surplus for property, plant, and equipment and intangible assets (IAS 16 and IAS 38);
- Remeasurements of defined benefit plans (IAS 19);
- Gains and losses on translating the financial statements of a foreign operation (IAS 21);
- Gains and losses from investments in equity instruments measured at fair value through OCI (IFRS 9);
- The effective portion of gains and losses on hedging instruments in cash flow hedges and on hedging instruments that hedge investments in equity instruments measured at FVOCI (IFRS 9);
- The amount of the change in fair value of liabilities designated at FVPL that is attributable to changes in the liability's credit risk (IFRS 9); changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value (IFRS 9); and

- Changes in the value of the forward elements of forward contracts and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument under IFRS 9 (IAS 1.7).

Specific IFRS (such as those listed above) provide guidance about *whether* and *when* items previously recognized in OCI are reclassified (commonly referred to as "recycled") to PL. Certain items may be reclassified to PL if specific conditions occur. OCI items are grouped in the operating statement, in accordance with other IFRS, into those items that:

- Will be reclassified to PL at a future point in time, based upon certain conditions; and
- Will never be reclassified to PL.

The disclosure of reclassification (also called "recycling") adjustments helps users understand how items recognized in PL are related to other items recognized in equity in two different periods. Reclassification adjustments arise, for example, on (a) disposal of a foreign operation, and (b) when some hedged forecast cash flow affects PL in cash flow hedges. Thus, if an entity sold its investment in a foreign operation, any unrealized gain or loss previously recognized as OCI would be reclassified to PL. Therefore, those unrealized gains or losses on such investment must be deducted from OCI in the period in which realized gains or losses from the sale of this investment are reported in PL to avoid including them in total comprehensive income twice (see Chapter 12).

Reclassification adjustments, for example, do *not* arise (are recognized in OCI, but are not reclassified to PL in subsequent periods) on the following items: (a) changes in revaluation surplus, and (b) remeasurement of defined benefit pension plans. For example, changes (gains and losses) in the revaluation surplus for property, plant, and equipment and intangible assets may be transferred to retained earnings in subsequent periods, when the asset is derecognized or used. Actuarial gains and losses are reported in retained earnings in the period in which they are recognized as OCI (see Chapter 22). Also, under IFRS 9, reclassification adjustments do not arise if a cash flow hedge or the accounting for the time value of an option (or the forward element of a forward contract or the foreign currency basis spread of a financial instrument) result in amounts that are removed from the cash flow hedge reserve or a separate component of equity, respectively, and included directly in the initial cost or other carrying amount of an asset or a liability; these amounts are directly transferred to assets or liabilities (IAS 1.96).

In accordance with IAS 12, an entity allocates income tax expense or benefit in the period among certain items of comprehensive income and equity (called *intra-period tax allocation*). Thus, the amount of income tax relating to each item of OCI, including reclassification adjustments, is disclosed separately either on the face of the statement(s) or in the notes.

An entity may include additional line items when presenting PL and OCI or change their descriptions if it is necessary to explain the elements of financial performance that are specific to an industry. For example, financial institutions may want to provide descriptions to certain material information that is specific to transactions that occur in this industry, such as interest income from commercial real estate loans.

**Information to Be Presented in the Statement(s) of PL and OCI or in the Notes**

The nature and amount of all material items of income or expense are disclosed separately either on the face of the statement(s) or in the notes. Some specific transactions require separate disclosure if they are material. These transactions include: (a) write-downs of inventories or of property, plant, and equipment and any subsequent reversals; (b) restructuring activities and costs associated with these activities and subsequent reversals of any provisions accrued for the costs of restructuring; (c) disposals of material components of property, plant, and equipment; (d) disposals of investments; (e) discontinued operations; (f) settlement of litigation; and (g) other reversals of provisions (IAS 1.98).

## 10 Operating Segments (IFRS 8)

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### Learning Objectives

To understand:

- Identifying the chief operating decision maker
- Identifying operating segments
- Determining reportable operating segments
- Presenting disclosure of reportable segments
- Significant judgments required in providing segment disclosure.

### Introduction

This chapter sets out the accounting requirements for reporting information about an entity's operating segments in accordance with IFRS 8 *Operating Segments*. The disclosure requirements contained in this Standard are designed to improve the usefulness of financial statement information and to help users evaluate an entity's business activities and the economic environments in which it operates. Operating segment information is critical in order to assess the risks and returns of each individual segment, and the entity as a whole. IFRS 8 introduces the management approach

to disclosing information about segments that allows users of financial statements to evaluate an entity's operations "through the eyes of management."

This chapter examines the accounting requirements for reporting information about operating segments in accordance with IFRS 8. The main issues that arise include properly identifying the entity's chief operating decision maker (CODM), distinguishing each operating and reportable segment, and providing adequate segment disclosures. Significant judgments are required with regard to disclosing segment information.

### Benefits of Segment Reporting

Many conglomerates have expanded into more diversified businesses that operate in entirely different industries. For example, entities that were previously considered to be nonfinancial in the scope of their operations (e.g., automobile producers) have diversified into financial services activities (e.g., financing, insurance, leasing), which have a radically different asset composition, profit or loss statement format, and debt-to-equity structure. Consolidated financial statements present financial information of businesses operating in different industries as if the group were one single company. As a result, in order to make informed economic decisions, investors may not be able to sufficiently analyze financial performance from the consolidated statement of financial position and profit or loss statement alone. Therefore, segment information helps investors assess which businesses in which industry and/or geographical region are profitable, and which are experiencing a deteriorating financial position.

Segment information provides useful information by business and/or geographical segment that informs users of an entity's revenues, operating results, assets, etc. Investors and other financial statement users need segment information to evaluate differences among business segments with regard to risks, returns, and growth. Such information may enable them to predict future financial performance of those segments as well as the entity as a whole. Segment information also helps in assessing the value of investments in other entities and the economic environment in which they operate. Because domestic and foreign operations may involve differing risks to the entity, segment information provides disclosures about the entity's foreign revenues, assets and major customers.

Entities (i.e., preparers of the financial statements) may be hesitant in providing disclosures on operating segments because of the perception of the potential for competitive harm or even erosion of shareholder value, by disclosing commercially sensitive information to competitors, regulatory agencies, labor unions and other constituencies. In addition, judgments that are required in the identification of segments and cost (or asset) allocation between segments may obscure the usefulness of segment information. There are also costs associated with reporting segment information. However, when assessing risks and returns, segment information may be more relevant than consolidated data.

IFRS 8 introduces the management approach for defining reportable segments, which requires disclosure of segment information that is actually being used internally and presented to the entity's chief operating decision maker (CODM) in order to allocate resources to the segment and assess its performance. This approach allows users of financial statements to evaluate an entity's operations "through the eyes of management," thus enhancing their ability to predict actions of management and prospects for future cash flows of the entity. Also, since such information is readily available, it can be provided with low incremental costs. This differs from the approach under the previous standard, IAS 14 *Segment Reporting*, which required disclosure of two sets of segments, one based on operations and the other on geographic areas.

Critics of the management approach state that the comparability of segment information among entities in the same industry may be reduced if the entities are organized differently and the CODM uses different measures of segment financial information to make resource allocation decisions and to assess performance. For example, this approach permits for non-IFRS measures of segment profit

or loss, as long as that measure is reviewed by the CODM, and does not require this measure to be consistent with the allocation of assets to reportable segments. However, this risk should be offset by the comparability gained from certain entity-wide disclosures in IFRS 8 about products and services, geographical areas, and major customers.

#### Illustration 10.1 Segment Reporting

A sample of the annual reports of 150 UK companies revealed that only a minority of companies disclosed that they used non-IFRS measures when implementing IFRS 8. This study suggests that segment information regularly reviewed by the CODM in UK companies appears to be prepared in accordance with IFRS (Crawford *et al.* 2010).

#### Key Terms Defined

**Operating segment.** An operating segment is a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
- whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
- for which discrete financial information is available.

(Source: IFRS 8 Appendix A)

### IFRS 8, OPERATING SEGMENTS

#### Objective and Scope

The objective of IFRS 8 is to disclose segment information that enables financial statement users to evaluate the nature and financial effects of business activities on each economic environment in which the business operates (IFRS 8.1).

The disclosure requirements provided in this Standard apply to separate (or individual) and consolidated financial statements of entities that have debt or equity instruments traded in a public market, or that file or are in the process of filing financial reports with a securities commission or other regulatory organization for the purpose of issuing instruments in a public market. If a financial report contains both the consolidated statements of a parent as well as the parent's separate financial statements, then segment information is only required to be provided for the consolidated set of financial statements.

An entity that is not required to apply IFRS 8 may nonetheless choose to disclose information about segments. When an entity voluntarily decides to present such information, it cannot describe the information as segment information (i.e., an alternative heading to this disclosure should be provided).

#### Executive Summary

- IFRS 8 provides requirements for disclosures about an entity's operating segments, its products and services, the geographical areas in which it operates and its major customers.
- In general, the standard applies to publicly traded entities. However, if the financial report includes both the consolidated financial statements as well as separate financial statements of a parent, segment information is required only in consolidated financial statements.

- The Standard introduced the management approach, which requires disclosing the same segment information that the entity's chief operating decision maker (CODM) uses internally to allocate resources to the segment and assess its performance.
  - Identifying the entity's CODM is a critical step in meeting the requirements for segment disclosures.
  - An entity may aggregate certain operating segments that have similar economic characteristics and comply with specific aggregation criteria.
  - Reportable segments are determined based on quantitative thresholds of revenue, profit or loss, and assets.
  - The amounts disclosed for each reportable segment is the measure reported to the CODM which can be different from the measures used in the primary financial statements. Therefore, further disclosures need to be provided to reconcile the segment measures to the amounts recognized in the financial statements.
  - An explanation of measurement policies is required; i.e., how segment profit or loss, segment assets, segment liabilities and certain income and expense items are measured. In addition, total reportable segment amounts disclosed must be reconciled to corresponding amounts in the entity's financial statements.
  - Disclosures of certain entity-wide information are required even by entities that have only a single reportable segment. However, entities are exempt from reporting information that is not available or the costs to generate the information would be excessive.
- General and entity-wide disclosures include information about products and services, geographical areas, major customers, and the approach used in identifying an entity's reportable segments.
- Any changes in the composition of an entity's reportable segments result in the restatement of comparative information for earlier periods.
  - Significant judgments are required with regard to disclosing information about operating segments.

#### Steps in Applying IFRS 8

Key steps in applying IFRS 8 include:

- Identifying operating segments;
- Aggregating operating segments;
- Determining reportable operating segments;
- Disclosing information about reportable segments.

#### Identifying Operating Segments

Operating segments are identified using different bases such as products, services, customers, geography, individual plant, and so forth. More than one basis of segmentation can be used. The definition of an operating segment includes components of an entity that sell primarily or exclusively to other operating segments of the entity; i.e., vertically integrated operations (e.g., oil and gas entities).

A head office function, such as accounting, finance, information technology and human resources, generally would not be identified as an operating segment because it does not generate revenues, or it may earn revenues that are only incidental to the activities of the entity. However, a head office function that engages in a treasury operation that earns significant investment income and incurs expenses would qualify. IFRS 8 specifies that an entity's post-employment benefit plans are not operating segments.

Key elements in identifying operating segments include:

1. **Identifying the CODM**

An essential step in the application of IFRS 8 is to identify the entity's chief operating decision maker (CODM). This term defines a function rather than an individual with a specific title. The function of the CODM is to allocate resources to and assess performance of the segments of the entity. The CODM usually is the highest level of management, for example the chief executive officer (CEO), chief operating officer (COO) or a group of senior executives (e.g., a management committee). The operating segment usually has a segment manager who reports to the CODM.

2. **A component can earn revenues or incur expenses**

A component of the entity identified as an operating segment may engage in business activities for which it has yet to earn revenue. Thus, the test is whether an operating segment *may* earn revenues and incur expenses. Consequently, despite a lack of revenues, start-up operations may be operating segments before earning revenues. Operating segments can be identified on a number of different bases such as products, services, customers, geography.

3. **Operating results are regularly reviewed by the CODM for resource allocation and performance evaluation**

Judgment may be needed to assess the extent to which the operating results of components of the entity are aggregated for the purpose of review by the CODM and the frequency of review at the more detailed level. If it is difficult to identify which set of information is used for resource allocation decisions and assessing performance, factors such as the nature of the business activities of each component, the existence of segment managers responsible for them, and information presented to the board of directors may be considered. In practice, if the CODM reviews reports on a quarterly or more frequent basis, this would satisfy the requirements.

4. **Discrete financial information is available**

For a component to be an operating segment, the CODM must have the financial information about the operating results (e.g., gross margin, gross and net operating result) of the component. This information should be sufficiently detailed to allow the CODM to make resource allocation decisions and to assess performance.

**Example 10.1 Different Types of Operating Segments**

Global Entity (GE) has four business components A, B, C and D. Two of these business components A and B are manufacturing plants located in the U.S. Each plant manufactures and sells a different product to customers located in the U.S. The CEO of each plant (the CODM) makes decisions about allocating resources and assessing performance. Two other components, C and D are manufacturing plants located in Brazil, that are organized to mirror the U.S. operations but each manufactures and sells products to customers in Brazil. GE's vice-president for foreign operations in Brazil is responsible for assessing performance and making resource allocation decisions for the Brazil operation as a whole.

GE has three operating segments. Segments A and B are determined on a product-line basis and Segment Brazil, which includes components C and D, is determined on a geographic basis.

**Aggregating Operating Segments**

An entity may aggregate certain operating segments that have similar economic characteristics and comply with specific aggregation criteria. Significant judgments may be required in applying the aggregation criteria that require an entity to show the ability to demonstrate similar economic characteristics of those aggregated segments (e.g., trends in sales growth or levels of capital investments).

According to IFRS 8, an entity is permitted to aggregate two or more operating segments into a single operating segment if the following criteria are met:

1. Aggregation is consistent with the core principle of [IFRS 8];
2. The segments have similar economic characteristics; and
3. The segments are similar in each of the following respects:
  - The nature of the products and services;
  - The nature of the production processes;
  - The type or class of customer for their products and services;
  - The methods used to distribute their products or provide their services; and
  - If applicable, the nature of the regulatory environment, e.g., banking, insurance or public utilities.

(IFRS 8.12)

**Example 10.2 Not to Aggregate**

Clean Energy (CE) produces energy products in two European countries, each of which is determined to be a reportable segment. The CODM reviews operating results of each segment separately in order to make decisions about resources to be allocated and to assess performance of each one individually. The two segments have similar economic characteristics (e.g. similar long-term average gross margins and sales growth). Although CE is permitted to aggregate these two segments, the entity decides to report them separately in order to help investors better understand its performance and prospects for future cash flows.

**Determining Reportable Segments**

IFRS 8 provides quantitative thresholds to determine reportable segments. Operating segments that meet *any* of the following quantitative thresholds must be reported separately:

1. The segment's reported revenue (including external sales and intersegment sales or transfers), is 10% or more of the combined revenue (internal and external) of all operating segments.
2. The amount of the segment's reported profit or loss is 10% or more of the greater of (1) the combined reported profit of all operating segments that did not report a loss and (2) the combined reported loss of all operating segments that reported a loss.
3. The segment's assets are 10% or more of the combined assets of all operating segments.

(IFRS 8.13)

Operating segments that meet any one of the above quantitative tests are reported separately. Additionally, operating segments that do not meet any of the tests may be considered reportable, if management believes that such information would be useful to users of the financial statements or to meet the 75% test. The 75% test is the final test that is conducted after all reportable operating segments have been identified. The 75% test is satisfied if the *combined* revenue of *all* reportable operating segments is greater than 75% of total external revenue. If the combined revenue of all reportable operating segments doesn't constitute 75% of total external revenues, then additional operating segments should be added until the test is satisfied.

Combined amounts (i.e., combined revenues, profit, loss, or assets) used as quantitative thresholds are the total amounts for all operating segments before eliminating intra-group transactions, but excluding activities that are not operating segments (e.g., corporate activities). The measures of the segment amounts used for all tests represent the amounts reported to the CODM.

**Example 10.3 Reportable Segments—Applying Quantitative Thresholds**

	Segment revenues	Segment profit or loss	Segment assets
Segment A	\$4,000	\$800	\$1,000
Segment B	1,000	150	100
Segment C	<u>400</u>	<u>(50)</u>	<u>80</u>
Total	<u>\$5,400</u>	<u>\$900</u>	<u>\$1,180</u>

**Threshold amounts:**

Total revenue: \$540 ( $\$5,400 \times 10\%$ )

Total profit (or total loss): \$95 ( $\$950 \times 10\%$ ), representing 10% of the greater of the absolute amount of all operating segments not reporting a loss ( $800 + 150$ ) and all operating segments reporting a loss (50)

Total assets: \$118 ( $\$1,180 \times 10\%$ )

Considering each of the operating segments as reportable segment:

Segment A exceeds the revenue threshold ( $4,000 > 540$ ), the profit threshold ( $800 > 95$ ) and the asset threshold ( $1,000 > 118$ )

Segment B exceeds the revenue threshold ( $1,000 > 540$ ), the profit threshold ( $150 > 95$ ); but not the asset threshold ( $100 < 118$ )

Segment C meets the loss threshold ( $50 > 5$ ); but does not exceed the revenue threshold ( $400 < 540$ ), nor the asset threshold ( $80 < 118$ ).

Therefore, all three segments (Segments A, B and C) meet at least one quantitative threshold and thus all are reportable.

**Disclosing Information about Reportable Segments**

In accordance with the core principle of IFRS 8, an entity is required to disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. An entity presents the following categories of information:

- General information;
- Information about profit or loss, assets and liabilities;
- Reconciliations of segments amounts to the entity's combined amounts; and
- Entity-wide disclosures.

**General Information**

IFRS 8 requires the following general disclosures:

- The factors used to identify the entity's reportable segments, discussion of how the entity is organized in order to make key allocation decisions and to assess performance, and
- The types of products and services from which each reportable segment generates its revenues.

**Information about Profit or Loss, Assets and Liabilities**

1. For each reportable segment, information about profit or loss, assets, and liabilities should include:
  - A measure of profit or loss and total assets
  - A measure of total liabilities if this amount is regularly presented to the CODM
  - The amount of any of the following items that are either included in the measure of segment profit or loss reviewed by the CODM, or are otherwise regularly provided to the CODM:
    - Revenues from external customers;
    - Revenues from transactions with other operating segments within the entity;
    - Interest revenue and expense (may only be reported on a net basis when specific conditions are met)\*;
    - Depreciation and amortization;
    - Material items of income and expense disclosed in accordance with IAS 1;
    - The entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;
    - Income tax expense or income; and
    - Material noncash items other than depreciation and amortization.

\* An entity may only report interest revenue and expense on a net basis when a majority of the segment's revenues are from interest and the CODM relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In such situation, an entity may report the segment's interest revenue net of its interest expense and disclose this fact in the notes.

2. For each reportable segment, the following items are included in the measure of segment assets reviewed by or regularly provided to the CODM:
  - The investment in associates and joint ventures accounted for by the equity method, and
  - Total additions to non-current assets other than financial instruments, deferred tax assets, postemployment benefits and rights arising under insurance contracts.
3. An explanation of the measurement basis of segment information, as it is provided to the CODM, including the following:
  - The basis of accounting for intersegment transactions;
  - The nature of any differences between the measurement of the following items in the reported segment information and this information presented in the entity's IFRS financial statements: profit or loss before income tax and discontinued operations, assets and liabilities.
  - The nature and effect of accounting policy or measurement differences for allocating central costs or jointly used assets and liabilities to segments, including any asymmetrical allocations to reportable segments (e.g., when depreciation expense is allocated to the reportable segment but the related depreciable asset is not).

**Reconciliations**

IFRS 8 requires reconciliations of the reportable segments' amounts to the corresponding entity's amounts with regard to the following:

- The total of the reportable segments' revenues to the entity's revenue;
- The total of the reportable segments' measures of profit or loss to the entity's profit or loss before income tax expense and discontinued operations (if income tax is allocated to segments, to profit or loss after tax);

- The total of the reportable segments' assets to the entity's assets;
- The total of the reportable segments' liabilities to the entity's liabilities (if segment liabilities are reported to the CODM); and
- All other material reconciling items must be separately identified and described.

(IFRS 8.28)

**Entity-Wide Disclosures**

Disclosures of certain entity-wide information are required even by entities that only have a single reportable segment. However, these disclosures are not necessary if the required information is not available, the costs to generate the information are excessive, or if such information is provided in the reportable segment disclosures (this fact would need to be disclosed). Necessary disclosures include:

1. Information about products and services
  - External revenues on an IFRS basis for each group of similar products and services.
2. Information about geographical areas
  - External revenues attributed to (1) domestic operations (i.e., the entity's country of domicile) and (2) all foreign operations in total and separate information about revenues attributed to individual foreign countries, if material (the basis on which revenues are attributed to individual countries needs also be provided).
  - Non-current assets (other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts) (1) domestic (located in the entity's country of domicile), and (2) foreign (located in all foreign countries in total). If assets in an individual foreign country are material, separate disclosure must be made.
  - The amounts reported should be reported on an IFRS basis. An entity may provide, in addition to the required information, subtotals of geographical information about groups of countries.
3. Information about major customers
  - If revenues from a single external customer amount to 10% or more of an entity's revenues, the total revenues from each such customer and the identity of the segments reporting the revenues must be disclosed. For this requirement, entities under common control and entities under the control of a particular government (e.g., local, national or international) are considered in each case a single customer.

**Illustration 10.2 EVN's Segment Reporting**

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**23. Forward-looking statements**

The preparation of the Consolidated financial statements in accordance with the generally accepted IFRS accounting methods requires making estimates and assumptions that have an effect on the assets and liabilities, as well as the income and expenses, shown in the Consolidated

financial statements, and on the amounts shown in the Consolidated notes. The actual values may deviate from the estimates. The assumptions and estimates are continuously reviewed.

Impairment tests require estimates especially of future cash flows. Future changes in the overall situation affecting the economy, the industry or the company may reduce cash inflows and thus lead to an impairment of goodwill (see note 21. Procedures and effects of impairment tests).

The measurement of the existing provisions for pensions and obligations similar to pensions as well as of the provisions for severance payments is based on assumptions relating to the discount rate, the age of retirement, life expectancy and future pension and salary increases (see note 49. Non-current provisions).

Further applications of economic assumptions and estimates involve, for one, determining the useful life of non-current assets (see notes 6. Intangible assets and 7. Property, plant and equipment) as well as recognising provisions for legal proceedings and environmental protection (see note 17. Provisions) and, for another, measuring receivables and inventories (see notes 12. Inventories and 13. Trade and other receivables). All estimates are based on historical data and other assumptions considered accurate in the given circumstances.

**24. Segment reporting**

Operating segments are identified solely on the basis of the internal organisational and reporting structure and information prepared for internal management decisions (the "management approach"). The segment breakdown into "Generation," "Energy Trade and Supply," "Network Infrastructure Austria," "Energy Supply South East Europe," "Environmental Services" and "Strategic Investments and Other Business" conforms in full to the internal reporting structure.

The assessment of all segment information is consistent with IFRS. EBITDA is the primary indicator used to measure the segments' performance internally. For each segment it represents the total net operating profit or loss before interest, taxes, amortisation of intangible assets and depreciation of fixed assets of the companies included in the segment, taking inter-segment income and expenses into account (see the section on the principle of segmentation and transfer prices for information about segment allocation and the settlement of inter-segment transactions).

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The segments encompass the following activities:

Business areas	Segments	Activities
Energy business	Generation	Electricity generation from thermal sources and renewable energies at Austrian and international locations
	Energy Trade and Supply	Sourcing of electricity and primary energy sources, trading an selling of electricity and natural gas to end customers and on wholesales markets as well as heat generation and sales
	Network Infrastructure Austria	Operation of regional electricity and natural gas networks as well as cable TV and telecommunications networks
	Energy Supply South East Europe	Operation of electricity networks and electricity sales in Bulgaria and Macedonia, heat generation and heat sales in Bulgaria, construction and operation of natural gas networks in Croatia, energy trading within the whole region



4. In 20X3, Bob's Big Builders (BBB) contracted with a Professional Basketball Team (PBT) to build an arena for their organization. PBT agrees to pay BBB \$50 million over a three-year period. The following data has been provided. Determine what amount of revenue, costs, and profit should be recognized each year.

Year	Actual Costs Incurred	Estimated Costs Remaining	Project Revenue	Estimated Total Cost	Estimated Total Profit
20X3	\$8,000,000	\$24,000,000	\$50,000,000	\$32,000,000	\$18,000,000
20X4	\$14,000,000	\$10,000,000	\$50,000,000	\$32,000,000	\$18,000,000
20X5	\$12,000,000		\$50,000,000	\$34,000,000	\$16,000,000

5. High End Entity (HEE) sells expensive food processors for \$1,200 each. One of its customers is short on cash and pays \$700 in cash and exchanges an old food processor for a new food processor. Show and explain the journal entry HEE should record for this transaction.

### Case

Music Entity (ME) has the following transactions during 20X1:

- On January 1, ME sells a piano to Recording Entity (RE). Because RE's cash is temporarily tied up with several other projects, ME devises a contract in which RE makes a \$20,000 down payment and then will pay an additional \$50,000 two years from now. The interest rate is 8%.
- On March 1, ME sells \$150,000 of sheet music and piano books to a national music store. ME offers a 2% discount to any customers who purchase more than \$100,000 worth of goods in a single purchase.
- On June 1, ME sells a high-end printer that it used to print music, books and other items in its operations (it doesn't typically sell printers like it). The book value of the printer when it is sold is \$10,000. Because the printer has been kept in really good condition, ME was able to sell the printer for \$15,000.
- On August 31, ME exchanges 20 trumpets (cost of \$2,000 and fair value of \$4,000) for music recording equipment and power cords to be used in its recording studio. Because the music recording equipment is customized with some unique software, there is no determinable fair value. The vintage record players, however, have a fair value of \$10,000.
- On December 1, ME sells 5 drum sets for \$2,200 each. As part of the sale, the buyers receive a year's worth of lessons (valued at \$100/month) that start on the date of the sale.
  - a. Explain how each of the five steps in the revenue model applies to each transaction. For any step that is not applicable, simply indicate it is not applicable. Indicate whether ME complied with the requirements for each step.
  - b. Prepare the journal entries for the transactions.

### Writing Assignment

Explain how two entities operating in the same industry with similar revenue streams could have different revenue recognition policies that lead to different amounts of recognized revenue but both be consistent with the fundamental qualitative characteristics (relevance and faithful representation) of the *Conceptual Framework*. Provide specific examples to support your reasoning.

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### Learning Objectives

To understand:

- Recognition and measurement of current tax
- Recognition and measurement of deferred tax
- Allocation of current and deferred tax to the related components of profit or loss, other comprehensive income and equity
- Presentation and disclosure of information about income taxes
- Significant judgments required in accounting for income taxes.

### Introduction

This chapter focuses on the accounting for income tax in accordance with IAS 12 *Income Taxes*. As defined in this IFRS, income tax includes current tax and deferred tax. For many financial

statement preparers and users the concepts underlying deferred tax are not intuitive. Applying these concepts may require a thorough knowledge of tax laws. This chapter presents the steps that an entity follows in the computation of current tax and deferred tax.

According to the *Conceptual Framework*, the objective of general purpose financial statements is to provide users with financial information about the reporting entity that is useful for economic decision making. Therefore, accounting for income taxes is on an accrual basis—to recognize the tax consequences of a transaction in the same year that transaction is recognized in financial statements. Financial information is useful if it is relevant and faithfully represents what it purports to represent. Thus, properly recognizing and measuring income tax fulfills the objective that the financial statements provide relevant information and faithfully represent the amount reported as income taxes. Such information is useful to users in assessing an entity's prospects for future net cash inflows. This tax information also enhances comparability of financial statements.

An entity is required to recognize the amount of taxes payable or refundable for the current year as well as future tax consequences of transactions and other events that have been recognized in the financial statements. Recognizing, measuring and disclosing information about income tax is the focus of this chapter. Significant judgment may need to be made in applying the provisions of IAS 12.

### Why Is Accounting for Income Taxes Important?

Income taxes often represent one of the largest expenditures that entities make. Therefore, tax planning strategies that could reduce future taxes or create taxable profit in appropriate periods, are of primary concern to decision makers. Accounting profit and taxable profit are two different concepts. Taxable profits of a particular period often differ significantly from accounting profits. The reason they differ is that the objectives of financial reporting and those of taxing authorities are different. Financial reporting is primarily focused on providing useful information to investors and creditors for making resource allocation decisions while tax reporting is primarily concerned with raising revenues from the public in a socially acceptable manner.

Consequently, the tax expense cannot simply be computed by multiplying accounting profits by the tax rate. For this reason, accounting for income taxes focuses on identifying and accounting for the differences between accounting profit and taxable profit. Those differences between accounting profit and taxable profit can be temporary or permanent. Temporary differences, which originate in one or more accounting periods and reverse in future periods, may result in future taxable or deductible amounts when the temporary differences reverse. Permanent differences (e.g., tax-free municipals in the U.S.) are disregarded when determining current tax liability, deferred tax and income tax expense.

The fundamental principle in IAS 12 is that a deferred tax liability or asset generally is recognized for the future tax effects of all temporary differences and carryforwards. Deferred taxes are calculated using the asset or liability approach. The differences between the carrying amounts of the assets and liabilities and their tax bases under tax laws are determined. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (or smaller), an entity recognizes a deferred tax liability (or deferred tax asset).

Accordingly, IAS 12 requires the measurement of deferred tax liabilities or assets to reflect the tax consequences that would follow the manner in which management expects to recover or settle the carrying amount of the entity's assets or liabilities. For example, management may expect to recover an asset by using it, by selling it or by a combination of use and sale. Management's expectation can affect the measurement of deferred taxes when different tax rates or tax bases apply to the profits generated from using and selling the asset.

A deferred tax liability represents some tax penalty the entity expects to face in the future as a result of transactions and other events that have been recognized in the financial statements. Without the recognition of a deferred tax liability, liabilities would be understated and profit overstated. Thus, there would be a risk that distributions of profit to owners might be higher than the entity could afford.

In contrast, a deferred tax asset represents some tax advantage the entity will benefit from in the future. Without the recognition of a deferred tax asset, assets would be understated and accounting profit lower than what it actually is. As a result, distributions to owners might be lower than what the entity could afford. Consequently, recognizing deferred tax liability or asset provides useful information for users of an entity's financial statements when assessing the entity's prospects for future net cash inflows.

### Key Terms Defined

**Accounting profit.** Profit or loss for a period before deducting tax expense.

**Taxable profit (tax loss).** Profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

**Tax expense (tax income).** The aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

**Current tax.** The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

**Deferred tax liabilities.** The amount of income taxes payable in future periods in respect of taxable temporary differences.

**Deferred tax assets.** The amounts of income taxes recoverable in future periods in respect of:

- Deductible temporary differences;
- The carryforward of unused tax losses; and
- The carryforward of unused tax credits.

**Temporary differences.** Differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either taxable temporary differences or deductible temporary differences.

**Deductible temporary differences.** Temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

**Taxable temporary differences.** Temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

**Tax base.** The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

**Tax expense (tax income)** comprises current tax expense (current tax income) and deferred tax expense (deferred tax income).

(Source: IAS 12.5)

## IAS 12, INCOME TAXES

### Objective and Scope

The objective of IAS 12 is to prescribe the accounting and reporting requirements for income taxes. This IFRS focuses on how to account for the current and future tax consequences of transactions and other events that have been recognized in the financial statements. Recognized income tax amounts comprise *current tax* and *deferred tax*.

Income taxes in this IFRS include all domestic and foreign taxes based on taxable profits as well as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on

distributions to the reporting entity. Accounting for government grants (covered by IAS 20) or investment tax credits is outside the scope of IAS 12; however, accounting for temporary differences arising from such grants or investment tax credits is within the scope of IAS 12.

### Executive Summary

- IAS 12 focuses on how to account for the current and future tax consequences of transactions and other events that have been recognized in the financial statements.
- Income tax is comprised of two components: current tax and deferred tax.
- Current tax is the amount of income tax payable or refundable on the entity's taxable profit or tax loss for the period, as determined by taxing authority.
- Deferred tax is tax payable or recoverable in future periods, generally as a result of the difference between the carrying amounts of the entity's assets and liabilities in the statement of financial position and their tax base (and the carryforward of currently unused tax losses and tax credits). It arises when recovery (settlement) of assets (liabilities) affects the amount of future tax payments.
- A temporary difference (taxable or deductible) is the difference between the accounting and tax base of an asset or liability. A deferred tax asset or liability is recognized for the future tax effects of all temporary differences and carryforwards.
- A deferred tax liability is recognized if the carrying amount for the accounting base of the asset (liability) is greater (less) than the tax base of that asset (liability).
- IAS 12 does not allow the recognition of a deferred tax liability for the excess of the carrying amount over the tax base of goodwill if it arises at the initial recognition of goodwill. Recognizing deferred tax assets or liabilities in a business combination affects the amount of goodwill.
- A deferred tax asset is recognized if the carrying amount of the asset (liability) is less (greater) than the tax base of that asset (liability), but only if it is probable that future taxable profit will be available to absorb the losses, credits or deductible differences.
- Current tax liabilities (assets) are measured at the amount expected to be paid to (recovered from) the taxation authorities using the tax rates and laws that have been enacted or substantively enacted by the reporting date.
- Deferred tax assets and liabilities are measured at tax rates expected to apply when the deferred tax asset (liability) is realized (settled) based on the tax rates and laws that have been enacted or substantively enacted by the reporting date. It reflects the tax consequences of how the entity expects at the end of the reporting period to recover (settle) the carrying amount of its assets (liabilities).
- Deferred tax assets and liabilities are *not* measured on a discounted basis.
- Current and deferred tax is recognized as income or an expense in profit or loss for the period, except if it arises from (a) a transaction or event the tax relates to that is recognized either in other comprehensive income or directly in equity; or (b) a business combination.
- An entity is allowed to offset current tax assets and current tax liabilities *only* if the entity (a) has a legally enforceable right to offset the recognized amounts, and (b) intends to settle on a net basis, or to realize the asset and settle the liability simultaneously.
- An entity can offset deferred tax assets and deferred tax liabilities only if (a) the entity has a legally enforceable right to set off current tax accounts; and (b) the deferred tax items relate to income taxes levied by the same taxation authority on the same taxable entity (or on different taxable entities in specific circumstances).
- The tax expense (income) related to profit or loss from ordinary activities is presented separately in profit or loss in the statement(s) of profit or loss and other comprehensive income.
- A number of specific disclosures about current and deferred income taxes are required to be presented in the financial statements under IAS 12.
- An entity must disclose in the summary of significant accounting policies or other notes significant judgments that management has made with regard to the scope, recognition and measurement of income tax.

### Steps in Accounting for Income Tax

Income tax is comprised of two components: current tax and deferred tax. Current tax is tax payable or refundable on the entity's taxable profit or tax loss for the current period or past periods, as determined in accordance with the rules established by the taxation authorities. Deferred tax is tax payable or recoverable in future periods, generally as a result of the entity recovering or settling its assets and liabilities for their current carrying amount, as well as the tax effect of the carryforward of currently unused tax losses and tax credits.

The steps necessary in accounting for income tax in accordance with IAS 12 are as follows:

1. Recognize and measure current tax.
2. Recognize and measure deferred tax.
3. Allocate current and deferred tax to the related components of profit or loss, other comprehensive income and equity.
4. Present and disclose the required information.

### Current Tax

An entity is required to prepare a tax return each year to determine the amount of a current tax liability on its taxable profit. If the tax payable exceeds the amount of tax paid during the reporting period, a tax liability is recognized. If the amount paid for the current and past periods exceeds the amount payable for those periods, the entity recognizes the excess as a current tax asset (note: tax payable for the year = taxable profits × tax rate). If an over-provision or under-provision for current tax is discovered before the financial statements are authorized for issue, the current tax expense/liability is adjusted in accordance with IAS 10.

An entity recognizes a current tax asset when a tax loss is incurred and the tax legislation allows this loss to be carried back to recover tax paid in a previous period. A tax loss arises in the reporting period in which tax deductions exceed taxable profits. In some jurisdictions, tax laws allow entities to use tax losses to offset taxable profit in one or more prior years, called a tax loss carryback. As stated in IAS 12, this tax benefit is recognized as an asset in the period in which the tax loss occurs, because it is probable that the benefit will flow to the entity and the benefit can be reliably measured. If a tax loss carryback is not permitted in the jurisdiction or the entity generated less profits in prior years than the amount of tax loss to be offset, the entity may be able to carry the tax loss forward with or without a time limit against taxable income in a future period. (See the procedure for recognizing a deferred tax asset for carryforward of unused tax losses discussed later in this chapter.)

#### Example 21.1 Net Operating Loss Carryback

In 20X4, Belmont Entity (BE) incurred \$50,000 in tax losses for the current tax year ending on December 31 (same as the end of the reporting period). BE's taxable income in 20X2 and 20X3 was respectively \$30,000 and \$25,000. The relevant tax rates were as follows: 22% in 20X2 and 20% in 20X3. In BE's jurisdiction, the tax legislation permits entities to carry back losses two years with the requirement to offset losses against the most recent period possible.

Consequently, the tax refund of \$10,500 is calculated as follows:  $(\$25,000 \times 20\%) + (\$25,000 \times 22\%) = \$10,500$ . In 20X4, BE must recognize a current tax asset as follows:

Dr. Current tax asset	10,500	
Cr. Profit or loss—income tax		10,500

## Deferred Tax

### General Principle

A deferred tax asset or liability is recognized for tax recoverable or payable in future periods as a result of past transactions or events. Deferred tax assets or liabilities arise from the difference between the carrying amounts of the entity's assets and liabilities in the statement of financial position (i.e., the accounting base) and their tax base, as well as from the carryforward of currently unused tax losses and tax credits.

No deferred taxes would arise if the entity expects to recover the carrying amount of an asset or settle the carrying amount of a liability without affecting taxable profit. However, a deferred tax liability or asset will arise and be recognized if the recovery of the carrying amount of an asset or the settlement of a liability would affect (increase or decrease) taxable profit.

The steps necessary in calculating a deferred tax provision in accordance with IAS 12 are as follows:

- Determine the accounting base of the asset or liability.
- Calculate the tax base of the asset or liability as well as other items that have a tax basis but are not recognized as assets or liability (e.g., items of income or expense that will be taxable or tax-deductible in the future).
- Calculate any temporary differences, unused tax losses and unused tax credits.
- Recognize and measure deferred tax assets and deferred tax liabilities.

### Accounting Base

The accounting base is the measurement of an asset, liability or equity instrument in the statement of financial position for financial reporting purposes (its carrying amount). The first step in determining whether deferred tax must be recognized is to identify those assets and liabilities that are expected to affect taxable profit if they are recovered or settled for their carrying amount. The assumption in accounting for deferred taxes is that assets will be realized (either through sale or by use within the business) for their carrying amounts, and liabilities will be settled at their carrying amounts. In practice, an entity may realize economic benefits from its assets above their carrying amount, for example when selling a machine at a gain, selling inventory at a markup above its cost or settling a liability that is recognized at a discounted amount.

If there is no expected tax effect when recovering or settling the carrying amount of an asset or liability, then no deferred tax is recognized. This circumstance will occur when no taxable income or amounts deductible from taxable income arise, when taxable income and deductible amounts are equal and a net effect is nil or when a nil tax rate applies to any taxable or deductible amounts in this jurisdiction.

#### Example 21.2 Asset Recovery Affects Taxable Income

Medical Supply Entity (MSE) deposited \$10,000 at a bank and will be collecting interest on a floating interest rate. For tax purposes, interest is taxed when cash is collected; for accounting purposes interest revenue is recognized on accrual basis. Consequently, MSE will need to account for deferred taxes to reflect the difference in interest revenue recognition for tax purposes and book purposes.

#### Example 21.3 Asset Recovery Does Not Affect Taxable Income

Florida Distributor holds an inventory of merchandise at cost. The cost of the inventory is tax-deductible when the inventories are sold. In this case, no deferred taxes will be recognized because the taxable income from sale of the inventory is assumed to be equal to its cost (the carrying amount) and the tax deduction on sale is also equal to the cost.

### Tax Base

The tax base is the measurement of an asset, liability or equity instrument in the statement of financial position for tax purposes. Other items that were not recognized in the statement of financial position may also have tax bases. For example, for accounting purposes, an entity recognizes research costs as an expense in calculating accounting profit, but for tax purposes, such costs may not be deducted in determining taxable profit or loss until a future year. This difference between the accounting base and tax base will result in a deductible temporary difference and the recognition of a deferred tax asset.

In some tax jurisdictions, the group of entities (a parent and its subsidiaries) may elect a single entity treatment for tax purposes. In such cases, the group of entities must follow the tax laws that govern the consolidated tax return in determining the tax basis of an asset or liability (and whether the recovery of an asset or settlement of a liability is expected to affect taxable profit). If the group files separate tax returns, the tax basis of each item is determined according to the tax law that governs separate tax returns of each entity within the group.

The tax base considers the amounts that will be included in taxable profit on recovery of the carrying amount of an asset or settlement of a liability. Therefore, management's expectations as to recovery or settlement of the carrying amount of an asset or liability will affect the recognition of deferred tax assets or liabilities (e.g., whether the cost of the asset will be recovered through use or sale). According to IAS 12, the tax base of

- An *asset* is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- A *liability* is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of revenue that will not be taxable in future periods.

#### Example 21.4 Tax Base

1. Equipment, \$20,000 net carrying amount (cost of \$50,000 and depreciation of \$30,000). For tax purposes, tax depreciation of \$40,000 has been deducted in determining taxable profit. The tax base of the equipment is \$10,000, the remaining cost that will be deductible in the future against revenues generated by using the equipment or sale.
2. Interest receivable, \$5,000, and dividend receivable, \$4,000. When determining taxable profit or loss, interest will be taxed on a cash basis and dividends are deductible against the economic benefits. The tax base of the interest receivable is nil and that of the dividends receivable is \$4,000.
3. Unearned subscription revenue with a carrying amount of \$2,000, collected in advance and recognized as a current liability. For tax purposes, the revenue was taxed when cash was received. The tax basis of the subscription revenue is nil.
4. Expenses of \$6,000 recognized on accrual basis. The related expenses are not deductible in determining taxable profit or loss. The tax basis of the accrued expenses is \$6,000.
5. Warranty (provision) obligations of \$5,000 to cover the repair of defective items sold during the reporting period. For tax purposes, payments under warranties are not deductible until actually paid or used. The tax basis of the warranty provision is nil because the amount deductible is equal to the carrying amount and the expense is tax-deductible when settled.