

MBA Financial Reporting

Financial Reporting Course Notes

1. Introduction to Financial Accounting

Section 1: Introduction to Financial Accounting

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These notes provide a basic introduction to financial accounting, for students with no prior knowledge of the subject.

The notes deal with six topics:

1. Bookkeeping and accounting;
2. Types of business organisations;
3. Final accounts;
4. The balance sheet;
5. The profit and loss account;
6. Double entry bookkeeping.

1.1 Bookkeeping and accounting

1.1.1 Bookkeeping

This involves the methodical recording of the day-to-day financial transactions of a business. These transactions are entered in books of prime entry and the nominal ledger.

Books (sometimes called journals) of prime entry are the first point of entry of transactions in the accounting system. Although transactions may be documented (e.g. invoices, cash register till rolls, petty cash vouchers, etc), until they are recorded in a book of prime entry, they are not part of the double entry accounting system. There are usually seven (or more) books of prime entry in most businesses, as follows:

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1. Cash receipts book/journal;
2. Cheque payments book/journal;
3. Petty cash book/journal;
4. Sales book/journal;
5. Purchases book/journal;
6. Wages book/journal;
7. General journal.

The heart of the accounting system is the nominal ledger, which is a collective term to refer to all the accounts of the business. Double entry bookkeeping is recorded in these accounts (see Section 1.6 further on).

A number of individuals in a business usually share the bookkeeping responsibilities. Thus, most businesses have a sales clerk, a debtors ledger clerk, a purchases clerk, a creditors ledger clerk, a wages clerk, a nominal/general ledger clerk etc. This reflects the importance from a control point of view of segregation of duties/separation of responsibilities in accounting systems.

1.1.2 Accounting

This involves a range of functions including the design of the accounting system, the preparation of monthly/quarterly management accounts, the preparation of interim/year-end financial accounts, the preparation of budgets, submission of information to State agencies such as the Revenue, the Industrial Development Authority (IDA) etc., preparation of loan applications for the banks etc.

1.1.3 Financial accounting vs. management accounting

The financial accountant is concerned with reporting to outsiders i.e. the shareholders/owners of the business, the Revenue and other government agencies, the banks etc. The management accountant reports accounting information internally to the management and employees of the business. In larger organisations the financial and management accountant are different individuals. The basic information used by the financial and management accountant comes from the bookkeeping system.

1.2 Types of business organisations

1.2.1 Sole trader

A single owner runs the business e.g. doctor

1. 2.2 Partnership

A number of individuals own and run the business together e.g. an accountancy practice

1.2.3 A company

A company is a business that is registered with the Registrar of Companies (Parnell House, Parnell Square) under the Companies Acts 1963 to 2003. This procedure is called incorporation. There are many different types of registered company:

Unlimited	<i>France</i>	<i>Germany</i>
Limited		
• Public (i.e. listed on a recognised stock exchange) (denoted by the letters plc [public limited company])	SA	GmbH
• Private (i.e. non-listed, closely held corporations) (denoted by the letters Ltd [limited])	SARL/EURL	

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Limited by guarantee

Almost all registered companies are limited liability companies i.e. the liability of the owners or shareholders of the company is limited to the amount of capital they put into the company. Thus, when a company is put into liquidation or is wound up the creditors of the company may not get fully paid. Because of limited liability, the liquidator of the company is not able to get more money from the shareholders to fully pay off the creditors.

The term '& company' is used to refer to the rest of the company of individuals in a partnership. This term has nothing to do with registered companies. A registered company is usually indicated by the letters plc/ltd.

1.2.4 Charities, Societies, State Bodies

These are businesses, usually of a specialist nature, which are legally incorporated under legislation specifically drawn up for the business/type of business.

1.3 Final accounts

All registered companies must submit annual returns to the Registrar of companies on an annual basis. The annual return includes the final accounts. Three primary financial statements almost always comprise the final accounts:

- a balance sheet of the company at the year-end date;
- a profit and loss (income statement) for the previous year's trading; and
- a cash flow statement for the previous year.

1.4 The Balance Sheet

The balance sheet is a snapshot picture of a company's financial position at a certain date. The balance sheet is always headed up with the name of the company to which it relates, the title of the account (i.e. the balance sheet) and the balance sheet date. The currency used is also shown at the top of the balance sheet and comparative amounts are shown for the previous year.

The layout is almost always vertical (i.e. the assets are shown first with the liabilities and capital underneath) although the more old fashioned horizontal layout (i.e. assets shown on the right/left hand side of the page with the liabilities/capital opposite) is occasionally seen.

The balance sheet, as its title indicates, must balance. Thus, two amounts/totals will appear on the balance sheet which will agree. These totals are distinguished by being double underlined. The balance sheet is a statement of the company's financial position. This is represented by a list of the company's assets, liabilities and capital.

1.4.1 Assets

An asset is something owned by a business which will provide future benefit to the business. If the future benefit will be obtained within the next year the asset is a 'current asset' e.g. stock (which will usually be sold to generate profit in the next year), debtors (who will usually pay their debts within one year) and cash at bank/on hand (which can be used within the next year.)

If the future benefit will be obtained after more than one year the asset is a 'fixed asset' (non-current asset) e.g. Land and buildings, plant and machinery, fixtures and fittings, motor vehicles all of which have a useful life of more than one year. Investments in shares of companies are also usually fixed assets since the investments are usually held for more than one year.

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There are three categories of fixed assets: Intangible assets (non-physical assets e.g. goodwill, brand values, legal rights such as patents, trademarks etc), tangible assets (physical assets) and financial assets (e.g. investments in other companies in the form of shares, loan stock etc).

An asset such as a motor vehicle could be classified as either a current asset or a fixed asset depending on how the asset is used. If the motor vehicle is purchased for use in the business over the useful life of the vehicle then it will be recorded as a fixed asset. If, on the other hand, it is purchased for resale (as in a motor dealer's business) the vehicle will be treated as a current asset called stock.

1.4.2 Liabilities

Liabilities are amounts owing/obligations to 'outsiders' (as opposed to the owners) of a business. The person/business to whom the money is owed is often referred to as a creditor. Moneys owing to creditors within one year are 'current liabilities' e.g. trade creditors for goods/services supplied to the business, taxation due, bank overdraft). Moneys owing after one year are long-term liabilities e.g. Bank term loan, debentures.

1.4.3 Capital/Equity

The owners (sole trader, partner, shareholder) of a business are treated from an accounting point of view as completely separate from the business. All transactions between the owners and the business are accounted for as if they, the owners and the business, were separate entities. When an owner puts money into a business, the business is treated as owing that money back to the owner. This 'liability' of the business to the owner is called 'capital'/'equity'. The business uses the owners' money to earn profits. Any profit earned is also considered to be owing back to the owner by the business and is treated as capital.

1.4.4 The balance sheet equation

The balance sheet is composed of assets, liabilities and capital. The balance sheet must always balance. This is because the following balance sheet equation must always hold true:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

This equation can be rearranged in a number of different ways (four of which are illustrated below):

Versions of the balance sheet equation
(1) $\text{Assets} = \text{Liabilities} + \text{Capital}$
(2) $\text{Assets} - \text{Liabilities} = \text{Capital}$
(3) $\text{Assets} - \text{Current Liabilities} = \text{Capital} + \text{Long-Term Liabilities}$
(4) $\text{Fixed Assets} + \text{Current Assets} - \text{Current Liabilities} = \text{Capital} + \text{Long-Term Liabilities}$

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1.4.5 Example balance sheet

Example Limited				
Balance sheet at 31 December 200Y				
	200Y		200X	
	€000	€000	€000	€000
ASSETS				
Non-current assets				
Property, Plant and Equipment				
Land and buildings		1,000		750
Computer equipment		2,500		2,250
Motor vehicles		<u>875</u>		<u>950</u>
		4,375		3,950
Current Assets				
Inventories	1,000		500	
Trade receivables	1,230		1,200	
Bank and cash	<u>340</u>		<u>890</u>	
		<u>2,570</u>		<u>2,590</u>
Total assets		<u>6,945</u>		<u>6,540</u>
EQUITY AND LIABILITIES				
Equity attributable to equity holders of the parent				
Equity share capital	3,000		3,000	
Retained income	<u>995</u>		<u>1,090</u>	
Total equity		3,995		4,090
LIABILITIES				
Non-current liabilities				
Bank term loan		1,000		1,000
Current liabilities				
Trade payables	850		780	
Current income tax liabilities	500		670	
Bank overdraft	<u>600</u>		—	
Total current liabilities		<u>1,950</u>		<u>1,450</u>
Total equity and liabilities		<u>6,945</u>		<u>6,540</u>

Note: Alternative presentations of the same information are equally acceptable (by varying the balance sheet equation).

CRH 2010 Q01: What type of assets does CRH show in its 2010 balance sheet?

CRH 2010 Q02: What type of liabilities does CRH show in its 2010 balance sheet?

CRH 2010 Q03: What type of capital/equity does CRH show in its 2010 balance sheet?

CRH 2010 Q04: Following the above approach, what form does the CRH balance sheet equation follow?

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Consolidated Balance Sheet

as at 31 December 2010

Notes	2010 €m	2009 €m
ASSETS		
Non-current assets		
14	8,892	8,535
15	4,305	4,095
16	1,037	962
16	149	128
24	194	244
27	385	337
	14,962	14,301
Current assets		
17	2,187	2,008
18	2,419	2,454
	112	77
24	14	5
22	37	66
22	1,730	1,372
	6,499	5,982
	21,461	20,283
EQUITY		
Capital and reserves attributable to the Company's equity holders		
29	244	241
29	1	1
29	3,015	3,778
29	(199)	(279)
	147	128
	(226)	(740)
	6,446	6,508
	10,328	9,637
	83	73
	10,411	9,710
LIABILITIES		
Non-current liabilities		
23	4,695	4,943
24	33	78
27	1,693	1,519
19	163	167
28	474	454
26	253	240
	7,311	7,401
Current liabilities		
19	2,686	2,471
	199	192
23	666	381
24	54	8
26	134	120
	3,739	3,172
	11,050	10,573
	21,461	20,283

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1.5 The profit and loss account

The profit and loss account is a statement of the revenues generated by a business during a given period of time less the expenses incurred in generating that revenue. The profit and loss account in a manufacturing/retailing business has three distinct sections which are shown one after the other in a vertical format.

The profit and loss account is headed up similarly to the balance sheet with the name of the company, the title of the account (i.e. Profit and loss account), the period to which the account relates. The currency used and comparative figures are also shown. If the revenues exceed the expenses then the balance on the profit and loss account will represent profit. If expenses exceed revenues then the business will have made a loss.

The three sections of the profit and loss account are:

The trading account("front office", "core business")

This records the revenue from selling stock/goods less the direct costs of those goods i.e. the purchase price of the goods. The balance on the trading account is the gross profit of the business for the period.

The profit and loss account ("back office")

This account adds sundry other non-core, non-trading revenue such as bank interest, discount received etc. to gross profit transferred in from the trading account and subtracts expenses other than those incurred in purchasing and manufacturing the goods for resale (which are recorded in the trading account). The expenses in the profit and loss account are often grouped into selling and distribution expenses, administration expenses and financial expenses. The balance remaining on this account is the net profit of the business for the period.

The profit and loss appropriation account

This account records the amount of the net profit of the business paid back to/ appropriated by the owners of the business. The balance remaining on this account is the profit retained by the business.

1.5.1 Revenues

Revenue is income which is usually received/receivable in cash. Examples are sales revenue, interest earned, rents receivable, dividend/investment income, discount received.

1.5.2 Expenses

Expenses are items used up in generating revenue. Examples are purchase costs, wages, administration costs etc. The list is endless. Assets and expenses are very similar. An asset is something which has future benefit. When the benefit is used up the asset becomes an expense. When the item is an asset it is recorded in the balance sheet. When the future benefit is used up, the asset is taken out of the balance sheet and is put into the profit and loss account as an expense instead.

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1.5.3 Example profit and loss account (pre-publication draft, not in a format suitable for publication)

Example Limited					
Trading, profit and loss account for the year ending 31 December 20X1					
	20X1		20X0		
	€'000	€'000	€'000	€'000	
Sales		5,000			
Cost of sales					
Opening stock	500				}
Purchases	4,500			C O M P A R A T I V E S	
Closing stock	(1,000)	(4,000)			
Gross profit		1,000			
Other operating income - Rents received		<u>200</u>			
Total profit		1,200			
Selling and distribution expenses					
Salesmen's salaries	(175)				}
Depreciation of motor vehicles	(25)				
Advertising	(50)	(250)			
Administration expenses					
Office salaries	(200)				
Depreciation of office buildings	(25)				
Depreciation of computers	(75)				
Stationery	(50)				
Bank charges	(20)	(370)			
Operating profit		580			
Financial expenses					
Interest received	50				}
Interest paid	(100)	(50)			
Profit before tax		530			
Taxation		<u>Nil</u>			}
Profit after tax		530			
Dividends paid		(625)			}
Net loss retained for year		(95)			
Retained profit brought forward		<u>1,090</u>			
Retained profit carried forward		<u>995</u>			

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CRH 2010 Q05: Where is the trading account shown in CRH's 2010 financial statements?

CRH 2010 Q06: What captions are used in CRH's 2010 income statement?

CRH 2010 Q07: Where are appropriations shown in CRH's 2010 accounts?

CRH 2010 Q07a: Why are appropriations shown there in CRH's 2010 accounts?

CRH 2010 Q08: What revenues can you identify in CRH's 2010 income statement?

CRH 2010 Q09: What expenses can you identify in CRH's 2010 income statement?

Consolidated Income Statement

for the financial year ended 31 December 2010

	2010 €m	2009 €m
Notes		
1	Revenue	17,173
3	Cost of sales	(12,363)
	Gross profit	4,810
3	Operating costs	(4,112)
1,4,6	Group operating profit	698
1,5	Profit on disposals	55
	Profit before finance costs	753
9	Finance costs	(380)
9	Finance revenue	133
10	Group share of associates' profit after tax	28
1	Profit before tax	534
11	Income tax expense	(95)
	Group profit for the financial year	439
	Profit attributable to:	
	Equity holders of the Company	432
	Non-controlling interests	7
	Group profit for the financial year	439
13	Basic earnings per Ordinary Share	61.3c
13	Diluted earnings per Ordinary Share	61.2c

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1.5.4 The asset stock

If stock were sold at the same price as purchased all movements of stock could be recorded in a stock account and the balance on the account would represent the unsold stock on hand at cost. Stock, however, is usually sold at a profit and if purchases and sales of stock were recorded in the one account the balance on the account would represent the unsold stock on hand together with the profit earned on the stock sold during the period. For this reason, movements of stock (i.e. purchases and sales) are recorded in separate accounts, the purchases and sales accounts. The only time the stock account is used is to record the opening/closing balance of stock at the beginning/end of an accounting period. The sales, purchases and stock accounts are shown in the trading account section of the profit and loss account:

Example trading account

Example Limited commenced trading by purchasing 100,000 units of stock @ €1 per unit. 80,000 units were sold @ €1.10 per unit. You are required to calculate the gross profit for the period.

	€'000	€'000
Sales		88
Cost of sales		
Opening stock	Nil	
Purchases	100	
Closing stock	(20)	(80)
Gross profit		<u>8</u>

1.6 Double entry bookkeeping

The accounting system in a business is made up of a great many different types of accounting documents. The nominal/general ledger is the central part of the accounting system. All transactions of the business are entered in the nominal/general ledger by means of double entry.

1.6.1 Debits (Dr.) and credits (Cr.)

All transactions are accounted for using double entry. Thus, all transactions are recorded twice (in different accounts each time) in the nominal ledger. One entry is the debit entry and the other is the credit entry. By convention, assets and expenses are recorded as debits. In paragraph 1.5.2 above it was explained that assets when used up become expenses. Thus, it is not surprising that they are both debits. Liabilities (including liabilities to owners i.e. capital) and revenue are represented by credits. Revenue gives rise to profit which is a liability to the owners of the business and is therefore a credit.

Every transaction has a dual effect. It is therefore wrong to think 'x transaction is a debit' or 'y transaction is a credit'. Every transaction has both a debit effect and a credit effect. It is because of this dual effect and because of double entry that the balance sheet balances (provided no errors are made!).

1. Introduction to Financial Accounting

Summary of the rules of double entry

Assets and liabilities

- Increase an asset Dr.
- Decrease an asset Cr.
- Increase a liability Cr.
- Decrease a liability Dr.

Revenues and expenses

- Increase an expense Dr.
- Decrease an expense Cr.
- Increase a revenue Cr.
- Decrease a revenue Dr.

2. Year-end adjusting entries

Section 2: Year-end adjusting entries
2.1 Preliminary and final trial balance
2.1.1 Preliminary trial balance
2.1.2 Moving from cash to accruals basis of accounting
2.1.3 Year-end adjustments
2.1.4 From the preliminary to the final trial balance
2.2 Opening/Closing stock
2.3 Accruals/Prepayments of expense items
2.3.1 Accruals of expense items
2.3.2 Prepayments of expense items
2.4 Fixed assets and depreciation
2.4.1 Example depreciation
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2.4.3 Accounting entries for depreciation
2.5 Fixed assets
2.5.1 Additions to fixed assets
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2.5.3 Accounting entries
2.6 Bad debts and bad debt provisions
2.6.1 Bad debts
2.6.2 Provisions for bad debts

2.1 Preliminary and final trial balances

2.1.1 Preliminary trial balance

The first step a business must take in preparing final accounts is to close off the nominal ledger accounts and extract a trial balance. The preliminary trial balance is used ① to ensure that the accounts balance (i.e. that the debits = the credits) and ② to summarise the information held in the nominal ledger.

2.1.2 Moving from cash to accruals basis of accounting

Almost all transactions (except for debtors/creditors in a credit sales/credit purchases system) are recorded when cash is received or paid. Except for very small businesses, few businesses use a cash only basis for recording transactions. Instead an 'accruals' system of accounting is used. This means that transactions are recognised in the accounts when they occur and not just when money is received/paid.

In practice, except for debtors/creditors, during the accounting period transactions are recorded on a cash received/paid basis. At the end of the accounting period the accounts are adjusted to the accruals basis of accounting before final accounts are prepared. These adjustments are called year-end adjustments.

2.1.3 Year-end adjustments

Year end adjusting entries are characterised as transactions which overlap two or more accounting periods. As a consequence, one side of a year-end adjusting double entry will affect the balance sheet and the other side the profit and loss account.

Year end adjusting entries arise in respect of expenses (and revenues) which overlap and relate to more than one accounting period. The objective in making year end adjusting entries is to:

2. Year-end adjusting entries

1. Match against revenue the expenses incurred in generating that revenue, whether paid for or not
2. Recognise revenue in the accounting period it is earned, and not just when the money is received.

Examples of year end adjusting entries are:

- Opening/Closing stock (already introduced at paragraph 1.5.4 earlier);
- Accruals;
- Prepayments;
- Depreciation;
- Bad debts.

2.1.4 From the preliminary to the final trial balance

The year-end adjustments are prepared after the preliminary trial balance is extracted. The preliminary trial balance is adjusted for the year-end adjustments to give the final trial balance from which the final accounts are prepared.

2.2 Opening/Closing stock

The adjustment for opening/closing stock was partly shown above in paragraph 1.5.4 dealing with the trading account. When the opening stock is sold during an accounting period, it is taken out of the balance sheet and is charged as part of Cost of Goods Sold in the trading account. At the end of an accounting period when the stock-take indicates that some goods purchased during the year remain unsold, the cost of this closing stock is taken out of purchases in the trading account and is transferred to the balance sheet to be charged as an expense in the next accounting period. The double entries are as follows:

Opening stock:	Dr. Trading account	Dr.	Cr.
	Cr. Stock (B/S)	X	X
Closing stock:	Dr. Stock (B/S)	X	
	Cr. Trading account		X

CRH 2010 Q10: Can you find the amounts for opening and closing stock (inventory) in CRH's 2010 financial statements?

CRH 2010 Q10a: Where is the other side of the double entry for opening and closing stock (inventory) in CRH's 2010 financial statements? Is the other side of the double entry disclosed separately in CRH's 2010 financial statements?

Consolidated Balance Sheet

as at 31 December 2010

Notes		2010 €m	2009 €m
	ASSETS		
	Non-current assets		
14	Property, plant and equipment	8,892	8,535
15	Intangible assets	4,305	4,095
16	Investments accounted for using the equity method	1,037	962
16	Other financial assets	149	128
24	Derivative financial instruments	194	244
27	Deferred income tax assets	385	337
	Total non-current assets	14,962	14,301
	Current assets		
17	Inventories	2,187	2,008

2. Year-end adjusting entries

17. Inventories

	2010 €m	2009 €m
Raw materials	622	585
Work-in-progress (i)	102	82
Finished goods	1,463	1,341
Total inventories at the lower of cost and net realisable value	2,187	2,008

(i) Work-in-progress includes €2 million (2009: €nil million) in respect of the cumulative costs incurred, net of amounts transferred to cost of sales under percentage-of-completion accounting, for construction contracts in progress at the balance sheet date.

An analysis of the Group's cost of sales expense is provided in note 3 to the financial statements.

Write-downs of inventories recognised as an expense within cost of sales amounted to €23 million (2009: €41 million).

None of the above carrying amounts has been pledged as security for liabilities entered into by the Group.

2.3 Accruals/Prepayments of expense items

These adjusting entries arise in respect of expenses which overlap and relate to more than one accounting period. The objective is to:

1. Match against revenue the expenses incurred in generating that revenue, whether paid for or not;
2. Recognise revenue in the accounting period it is earned and not just when the money is received

2.3.1 Accruals of expense items

Expense items are normally only recorded in the nominal ledger when they are paid. Thus, an expense incurred but not paid for will not appear in the accounts. In order to produce accurate accounts, expenses incurred but not paid for should be recorded or accrued. The double entry is:

	Dr.	Cr.
Dr. Expense account (profit and loss)	X	
Cr. Accrual (balance sheet)		X

An accrual is ① a liability to pay an expense in the future and is accordingly shown in the current liabilities section of the balance sheet and ② increases the expense (to which it relates) in the profit and loss account.

Example - Accrual (Expense incurred before it is paid for)

Rent €10,000 p.a. is payable at the end of each quarter.

Date paid	In respect of	Amount
31 March X7	1 st quarter	€2,500
2 July X7	2 nd quarter	€2,500
4 October X7	3 rd quarter	€2,500

- How much should be charged for rent in the profit and loss account?
- How much must be accrued?
- How should the accrual be shown in the accounts?

2. Year-end adjusting entries

CRH 2010 Q11: Can you find any amounts for accruals in CRH's 2010 financial statements?

19. Trade and Other Payables

	2010 €m	2009 €m
Current		
Trade payables	1,376	1,172
Construction contract-related payables (i)	163	174
Deferred and contingent acquisition consideration	26	32
Other payables	403	376
Accruals and deferred income	672	668
Amounts payable to associates	46	49
Total	2,686	2,471
Non-current		
Other payables	70	86
Deferred and contingent acquisition consideration (stated at net present cost) due as follows:		
- between one and two years	18	16
- between two and five years	46	35
- after five years	29	30
Total	163	167

(i) Construction contract-related payables include billings in excess of costs incurred together with advances received from customers in respect of work to be performed under construction contracts and foreseeable losses thereon.

Other than deferred and contingent consideration, the carrying amounts of trade and other payables approximate their fair value largely due to the short-term maturities of these instruments.

2.3.2 Prepayments of expense items

Expense items paid for and thus appearing in the accounts but not incurred should also be adjusted for. This type of adjustment is called a prepayment. An example of a prepayment is rent paid in advance/insurance paid in advance. The adjusting entry is:

	Dr.	Cr.
Dr. Prepayments (balance sheet)	X	
Cr. Expense (profit and loss)		X

Prepayments represent ① items paid for which will provide future benefit and are therefore shown as current assets in the balance sheet and ② reduces the expense (to which it relates) in the profit and loss account.

Example: Prepayment (Expense paid before it is incurred)

Stationery paid during year €80,550; Stock of stationery at year end €20,550

- How much should be charged for stationery in the profit and loss account?
- How much must be prepaid?
- How should the prepayment be shown in the accounts?

2. Year-end adjusting entries

CRH 2010 Q12: Can you find any amounts for prepayments in CRH's 2010 financial statements?

18. Trade and Other Receivables

	2010 €m	2009 €m
All current		
Trade receivables	1,700	1,608
Amounts receivable in respect of construction contracts (i)	342	350
Total trade receivables, gross	2,042	1,958
Provision for impairment	(151)	(158)
Total trade receivables, net	1,891	1,800
Other receivables (ii)	409	477
Amounts receivable from associates	1	1
Prepayments and accrued income	118	176
Total	2,419	2,454

The carrying amounts of trade and other receivables approximate their fair value largely due to the short-term maturities of these instruments.

(i) Includes unbilled revenue at the balance sheet date in respect of construction contracts amounting to €90 million (2009: €89 million).

(ii) Other receivables include retentions held by customers in respect of construction contracts at the balance sheet date amounting to €84 million (2009: €82 million).

Provision for impairment

The movements in the provision for impairment of receivables during the financial year were as follows:

At 1 January	158	161
Translation adjustment	7	(1)
Provided during year	50	71
Written-off during year	(56)	(68)
Recovered during year	(8)	(5)
At 31 December	151	158

Information in relation to the Group's credit risk management is provided in note 21 to the financial statements.

Aged analysis

The aged analysis of gross trade receivables and amounts receivable in respect of construction contracts at the balance sheet date was as follows:

Neither past due nor impaired	1,522	1,528
Past due but not impaired:		
- less than 60 days	193	112
- 60 days or greater but less than 120 days	100	89
- 120 days or greater	25	32
Past due and impaired (partial or full provision)	202	197
Total	2,042	1,958

Trade receivables and amounts receivable in respect of construction contracts are in general receivable within 90 days of the balance sheet date.

2. Year-end adjusting entries

2.4 Fixed assets and depreciation

Fixed assets of the business (which are used on a continuing basis) do not last forever. To write-off the cost in one year would not be in accordance with the matching principle. According to the matching / accruals principle, write-off / allocate the portion of the cost of the fixed asset that has been incurred in generating revenue.

CRH 2010 Q13: Where are the fixed assets disclosed in CRH's 2010 financial statements?

CRH 2010 Q13a: Where are the categories of fixed assets disclosed in CRH's 2010 financial statements?

CRH 2010 Q13b: Where are the categories of tangible fixed assets disclosed in CRH's 2010 financial statements?

Consolidated Balance Sheet

as at 31 December 2010

		2010	2009
		€m	€m
Notes	ASSETS		
	Non-current assets		
14	Property, plant and equipment	8,892	8,535
15	Intangible assets	4,305	4,095
16	Investments accounted for using the equity method	1,037	962
16	Other financial assets	149	128
24	Derivative financial instruments	194	244
27	Deferred income tax assets	385	337
	Total non-current assets	14,962	14,301

2. Year-end adjusting entries

14. Property, Plant and Equipment

	Land and buildings (i) €m	Plant and machinery €m	Transport €m	Assets in course of construction €m	Total €m
At 31 December 2010					
Cost/deemed cost	6,170	7,618	828	526	15,142
Accumulated depreciation (and impairment charges)	(1,395)	(4,295)	(560)	-	(6,250)
Net carrying amount	4,775	3,323	268	526	8,892
At 1 January 2010, net carrying amount	4,465	3,355	299	416	8,535
Translation adjustment	262	183	20	24	489
Reclassifications	36	93	(2)	(127)	-
Additions at cost (ii)	50	193	17	206	466
Arising on acquisition (note 31)	171	109	33	8	321
Disposals at net carrying amount	(51)	(86)	(15)	(1)	(133)
Depreciation charge for year	(151)	(536)	(84)	-	(771)
Impairment charge for year (iii)	(7)	(8)	-	-	(15)
At 31 December 2010, net carrying amount	4,775	3,323	268	526	8,892

The equivalent disclosure for the prior year is as follows:

At 31 December 2009					
Cost/deemed cost	5,710	7,113	803	416	14,042
Accumulated depreciation (and impairment charges)	(1,245)	(3,758)	(504)	-	(5,507)
Net carrying amount	4,465	3,355	299	416	8,535
At 1 January 2009, net carrying amount	4,321	3,567	380	620	8,888
Translation adjustment	(59)	(61)	(8)	(5)	(133)
Reclassifications	279	164	(2)	(441)	-
Additions at cost (ii)	70	207	17	238	532
Arising on acquisition (note 31)	46	51	9	4	110
Disposals at net carrying amount	(39)	(19)	(10)	-	(68)
Depreciation charge for year	(146)	(531)	(87)	-	(764)
Impairment charge for year (iii)	(7)	(23)	-	-	(30)
At 31 December 2009, net carrying amount	4,465	3,355	299	416	8,535
At 1 January 2009					
Cost/deemed cost	5,434	6,952	847	620	13,853
Accumulated depreciation	(1,113)	(3,385)	(467)	-	(4,965)
Net carrying amount	4,321	3,567	380	620	8,888

(i) The carrying value of mineral-bearing land included in the land and buildings category above amounted to €1,974 million at the balance sheet date (2009: €1,797 million).

(ii) Borrowing costs capitalised during the financial year amounted to €9 million (2009: €10 million). The average capitalisation rate employed to determine the amount of borrowing costs eligible for capitalisation was 5.5% (2009: 5.5%).

(iii) Property, plant and equipment assets are reviewed for potential impairment at each reporting date by applying a series of external and internal indicators specific to the assets under consideration; these indicators encompass macroeconomic issues including the inherent cyclical nature of the building materials sector, actual obsolescence or physical damage, a deterioration in forecast performance in the internal reporting cycle and restructuring and rationalisation programmes inter alia. In the event that there is an indication that an asset (or collection of assets) may be impaired, the Group measures the potential impairment using a discounted cash flow technique and records an impairment where the recoverable amount (being the higher of fair value less costs to sell and value-in-use) is less than the carrying amount. The impairment charge for 2010 of €15 million (2009: €30 million) represents charges across a number of business units in the Group, none of which is individually material.

Assets held under finance leases

The net carrying amount and the depreciation charge during the period in respect of assets held under finance leases were not material to the Group.

Future purchase commitments for property, plant and equipment

	2010 €m	2009 €m
Contracted for but not provided in the financial statements	305	272
Authorised by the Directors but not contracted for	143	139

2. Year-end adjusting entries

2.4.1 Example: Depreciation

Asset cost €5 million

Income from the asset is €5 million earned evenly over the asset's five-year life

<u>Income statement</u>	yr.1	yr.2	yr.3	yr.4	yr.5	Total
	€m	€m	€m	€m	€m	€m
Income	1	1	1	1	1	5
Expense	(5)	—	—	—	—	(5)
Profit and loss account	(4)	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>	<u>Nil</u>
Asset	-	-	-	-	-	-

OR

<u>Income statement</u>	yr.1	yr.2	yr.3	yr.4	yr.5	Total
	€m	€m	€m	€m	€m	€m
Income	1	1	1	1	1	5
Depreciation	(1)	(1)	(1)	(1)	(1)	(5)
Profit and loss account	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
<u>Balance sheet</u>						
Asset	-	-	-	-	-	-
Cost	5	5	5	5	5	5
Aggregate depreciation	(1)	(2)	(3)	(4)	(5)	(5)
Net Book Value	<u>4</u>	<u>3</u>	<u>2</u>	<u>1</u>	<u>Nil</u>	<u>Nil</u>

A fixed asset has a useful life of more than one year. As the usefulness of the asset is used up it is no longer appropriate to record the item as an asset in the books. When the asset is used up what was an asset becomes an expense. This expense is called "depreciation".

Depreciation is a measure of the cost of a fixed asset used up during an accounting period. Depreciation is a measure of the wearing out, consumption or reduction in the useful economic life of a fixed asset whether arising from use, passage of time or obsolescence through technological or market changes.

Depreciation decreases profits and assets each year in an effort to reflect the fact that assets are being used up in the revenue generation process. Depreciation has nothing to do with valuation of or replacement of the fixed assets.

Mechanics of entries for depreciation

1. Record asset at cost in fixed asset account on purchase/acquisition of the asset
2. Open depreciation expense account
3. Open aggregate (accumulated) depreciation account
4. Each year record annual depreciation in (i) the depreciation expense account and (ii) the aggregate (accumulated) depreciation account (i.e. record the double entry for depreciation)
5. Charge depreciation expense in the profit and loss account each year
6. Show the aggregate (accumulated) depreciation account in the balance sheet separately from the fixed asset account, and subtracted from the fixed asset account (Fixed asset minus aggregate (accumulated) depreciation = net book value (NBV))
7. When asset is fully depreciated (aggregate depreciation = cost of asset) continue to carry forward fixed asset balance and aggregate (accumulated) depreciation balance until asset is sold.

2. Year-end adjusting entries

Income statement

	yr.1	yr.2	yr.3	yr.4	yr.5	Total
	€m	€m	€m	€m	€m	€m
Income	1	1	1	1	1	5
Depreciation (Step 2)	Step 4(1)	(5)				
Profit and loss account	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
<u>Balance sheet</u>						
Asset	-	-	-	-	-	-
Cost (Step 1)	5	5	5	5	5	5
Agg Depreciation (Step 3)	Step 4(1)	Step 4(2)	Step 4(3)	Step 4(4)	Step 4(5)	(5)
Net Book Value	<u>4</u>	<u>3</u>	<u>2</u>	<u>1</u>	<u>Nil</u>	<u>Nil</u>

CRH 2010 Q14a: What was the charge for depreciation in CRH's 2010 financial statements?

CRH 2010 Q14b: On how many categories of tangible fixed assets was depreciation charged in CRH's 2010 financial statements?

CRH 2010 Q14c: On how many categories of tangible fixed assets was depreciation NOT charged in CRH's 2010 financial statements?

3. Cost Analysis

	2010 €m	2009 €m
Cost of sales analysis		
Raw materials and goods for resale	7,165	6,859
Employment costs (note 7)	1,869	1,834
Energy	694	582
Repairs and maintenance	410	370
Depreciation, amortisation and impairment (i)	601	570
Change in inventory (note 20)	(16)	442
Other production expenses*	1,640	1,853
Total	12,363	12,510

* Other production expenses primarily include equipment rental, sub-contractor costs and haulage.

Operating costs analysis

Selling and distribution costs	2,574	2,410
Administrative expenses	1,390	1,392
Other operating expenses	169	112
Other operating income	(21)	(6)
Total	4,112	3,908

(i) Depreciation, amortisation and impairment analysis

	Cost of sales		Operating costs		Total	
	2010 €m	2009 €m	2010 €m	2009 €m	2010 €m	2009 €m
Depreciation and depletion (note 14)	601	570	170	194	771	764
Impairment of property, plant and equipment (note 14)	-	-	15	30	15	30
Impairment of intangible assets (note 15)	-	-	87	11	87	11
Amortisation of intangible assets (note 15)	-	-	44	43	44	43
Total	601	570	316	278	917	848

2. Year-end adjusting entries

14. Property, Plant and Equipment

	Land and buildings (i) €m	Plant and machinery €m	Transport €m	Assets in course of construction €m	Total €m
At 31 December 2010					
Cost/deemed cost	6,170	7,618	828	526	15,142
Accumulated depreciation (and impairment charges)	(1,395)	(4,295)	(560)	-	(6,250)
Net carrying amount	4,775	3,323	268	526	8,892
At 1 January 2010, net carrying amount	4,465	3,355	299	416	8,535
Translation adjustment	262	183	20	24	469
Reclassifications	38	93	(2)	(127)	-
Additions at cost (ii)	50	193	17	206	466
Arising on acquisition (note 31)	171	109	33	8	321
Disposals at net carrying amount	(51)	(66)	(15)	(1)	(133)
Depreciation charge for year	(151)	(536)	(84)	-	(771)
Impairment charge for year (iii)	(7)	(8)	-	-	(15)
At 31 December 2010, net carrying amount	4,775	3,323	268	526	8,892
The equivalent disclosure for the prior year is as follows:					
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Reclassifications	279	164	(2)	(441)	-
Additions at cost (ii)	70	207	17	238	532
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Disposals at net carrying amount	(39)	(19)	(10)	-	(68)
Depreciation charge for year	(146)	(531)	(87)	-	(764)
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At 31 December 2009, net carrying amount	4,465	3,355	299	416	8,535
At 1 January 2009					
Cost/deemed cost	5,434	6,952	847	620	13,853
Accumulated depreciation	(1,113)	(3,385)	(467)	-	(4,965)
Net carrying amount	4,321	3,567	380	620	8,888

2.4.2 Calculation of depreciation

- Based on the original purchase price;
- Estimate of residual value may also be necessary;
- Estimate of economic life has to be made.

Methods of depreciation

There are a number of ways or methods of calculating depreciation, of which the following two are the most common.

(A) Straight Line Method

The most common method of depreciation is the straight-line method. Straight-line depreciation charges the same amount of the cost to each year of the useful life of the asset. Thus, the cost of the asset is written-off equally over the useful life of the asset.

$$\frac{\text{Cost} - \text{residual/scrap value}}{\text{Useful life of the asset}} = \text{Depreciation charge p.a.}$$

The scrap value of the asset at the end of its useful life is usually so small that it is assumed to be €nil.

2. Year-end adjusting entries

The example in paragraph 2.4.1 earlier is an example of the application of the straight line method of depreciation. The residual/scrap value was estimated at nil

Advantages

- Easy to understand and apply.

Disadvantages

- Some assets do not depreciate evenly.

(B) Reducing Balance Method

The cost of the asset is written-off using a constant percentage of the written-down value/net book value of the asset.

Calculations

Year 1 depreciation Cost x Rate of depreciation

Subtract year 1 depreciation from cost

Year 2 depreciation = (Cost – Depreciation year 1) x Rate of depreciation

Example

Asset cost €5 million

Of the €5 million income generated by use of the asset, more is expected to be earned in the earlier years of the use of the asset over its five-year life.

You are required to apply the reducing balance method of depreciation at a rate of 20% and to show how this would be reflected in the profit and loss account and balance sheet for years 1 to 5

	yr.1	yr.2	yr.3	yr.4	yr.5	Total
	€m	€m	€m	€m	€m	€m
Income (pattern assumed)	¹ 1.00	² 0.80	³ 0.64	0.51	0.41	3.36
Depreciation	(1.00)	(0.80)	(0.64)	(0.51)	(0.41)	(3.36)
Profit and loss account	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
Asset	-	-	-	-	-	-
Cost	5.00	5.00	5.00	5.00	5.00	5.00
Aggregate Depreciation	(1.00)	(1.80)	(2.44)	(2.95)	(3.36)	(3.36)
Net Book Value	<u>4.00</u>	<u>3.20</u>	<u>2.56</u>	<u>2.05</u>	<u>1.64</u>	<u>1.64</u>

1 €5 @ 20% = €1million

2 [€5 – €1_{Yr 1 depreciation}] @ 20% = €0.80 million

3 [€5 – €1_{Yr 1 depreciation} – €0.80_{Yr 2 depreciation}] @ 20% = €0.64 million etc

Advantages

- Maintenance may be low in early years and high in late years. Therefore maintenance + depreciation will be constant over all years.
- Higher depreciation in early years may reflect obsolescence.

Disadvantages

- More complicated to calculate.

2. Year-end adjusting entries

CRH 2010 Q15: Where does CRH disclose the method of depreciation followed in CRH's 2010 financial statements?

CRH 2010 Q15a: What methods of depreciation does CRH apply in its 2010 financial statements?

Property, plant and equipment – Note 14

The Group's accounting policy for property, plant and equipment is considered critical because the carrying value of €8,892 million at 31 December 2010 represents a significant portion (41%) of total assets at that date. Property, plant and equipment are stated at cost less any accumulated depreciation and any accumulated impairments except for certain items that had been revalued to fair value prior to the date of transition to IFRS (1 January 2004).

Repair and maintenance expenditure is included in an asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repair and maintenance expenditure is charged to the Consolidated Income Statement during the financial period in which it is incurred.

Borrowing costs incurred in the construction of major assets which take a substantial period of time to complete are capitalised in the financial period in which they are incurred.

In the application of the Group's accounting policy, judgement is exercised by management in the determination of residual values and useful lives. Depreciation and depletion is calculated to write off the book value of each item of property, plant and equipment over its useful economic life on a straight-line basis at the following rates:

Land and buildings: The book value of mineral-bearing land, less an estimate of its residual value, is depleted over the period of the mineral extraction in the proportion which production for the year bears to the latest estimates of mineral reserves. Land other than mineral-bearing land is not depreciated. In general, buildings are depreciated at 2.5% per annum ("p.a.").

Plant and machinery: These are depreciated at rates ranging from 3.3% p.a. to 20% p.a. depending on the type of asset.

Transport: On average, transport equipment is depreciated at 20% p.a.

Depreciation methods, useful lives and residual values are reviewed at each financial year-end. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset are accounted for by changing the depreciation period or method as appropriate on a prospective basis.

2. Year-end adjusting entries

2.4.3 Accounting entries for depreciation

The element of the cost of the fixed asset used up is taken out of the balance sheet and charged as depreciation each year in the profit and loss account. Rather than altering the cost of the asset in the balance sheet a separate account is opened to remove the depreciation. This account is called the ❶ accumulated depreciation / ❷ aggregate depreciation / ❸ Provision for depreciation account. As more and more of the cost of the fixed asset is used up the accumulated depreciation account gets bigger and bigger. The ledger entries are as follows:

Dr	Depreciation Expense (P&L)	X	
Cr	Accumulated Depreciation (B/S)		X

Being depreciation charge

In the balance sheet the accumulated depreciation balance is subtracted from the fixed asset account to leave the asset at what is called net book value (NBV).

2.5 Fixed assets

2.5.1 Additions to fixed assets

Purchases (or additions to) of fixed assets are recorded as follows:

Dr	Fixed Assets	X	
Cr	Bank or Creditors		X

Being purchase of fixed asset

If the asset is purchased during the year then it may be depreciated for ❶ a whole year or ❷ part of a year [month-by-month] or ❸ not at all depending on the depreciation policy of the business, e.g.:

1. Assets in use at end of year are to be depreciated on a straight line basis at 20% per annum ❶
2. Assets are to be depreciated on a straight line basis at 20% per annum, proportionately in the case of additions and disposals ❷
3. Assets in use at the start of the year are to be depreciated on a straight line basis at 20% per annum ❸
4. Assets are to be depreciated on a straight line basis at 20% per annum. No depreciation is to be provided in the year of addition or disposal ❸

2. Year-end adjusting entries

CRH 2010 Q16: Where would you find the additions to fixed assets in CRH's 2010 financial statements?
CRH 2010 Q16a: How much were the additions to CRH's fixed assets in 2010?

14. Property, Plant and Equipment

	Land and buildings (i) €m	Plant and machinery €m	Transport €m	Assets in course of construction €m	Total €m
At 31 December 2010					
Cost/deemed cost	6,170	7,618	828	526	15,142
Accumulated depreciation (and impairment charges)	(1,395)	(4,295)	(560)	-	(6,250)
Net carrying amount	4,775	3,323	268	526	8,892
At 1 January 2010, net carrying amount	4,465	3,355	299	416	8,535
Translation adjustment	262	183	20	24	489
Reclassifications	36	93	(2)	(127)	-
Additions at cost (ii)	50	193	17	206	466
Arising on acquisition (note 31)	171	109	33	8	321
Disposals at net carrying amount	(51)	(66)	(15)	(1)	(133)
Depreciation charge for year	(151)	(536)	(84)	-	(771)
Impairment charge for year (iii)	(7)	(8)	-	-	(15)
At 31 December 2010, net carrying amount	4,775	3,323	268	526	8,892

The equivalent disclosure for the prior year is as follows:

At 31 December 2009					
Cost/deemed cost	5,710	7,113	803	416	14,042
Accumulated depreciation (and impairment charges)	(1,245)	(3,758)	(504)	-	(5,507)
Net carrying amount	4,465	3,355	299	416	8,535
At 1 January 2009, net carrying amount	4,321	3,567	380	620	8,888
Translation adjustment	(59)	(61)	(8)	(5)	(133)
Reclassifications	279	164	(2)	(441)	-
Additions at cost (ii)	70	207	17	238	532
Arising on acquisition (note 31)	46	51	9	4	110
Disposals at net carrying amount	(39)	(19)	(10)	-	(68)
Depreciation charge for year	(146)	(531)	(67)	-	(764)
Impairment charge for year (iii)	(7)	(23)	-	-	(30)
At 31 December 2009, net carrying amount	4,465	3,355	299	416	8,535
At 1 January 2009					
Cost/deemed cost	5,434	6,952	847	620	13,853
Accumulated depreciation	(1,113)	(3,385)	(467)	-	(4,965)
Net carrying amount	4,321	3,567	380	620	8,888

2.5.2 Disposal of fixed assets

- Assets can be sold during their economic lives or at the end of their economic lives.
- When an asset is sold cash may be received in payment for it (sometimes the asset is a trade in, and a trade in allowance is obtained in place of cash proceeds on disposal).
- On disposal, the asset must be removed from the balance sheet as it is no longer an asset of the business. Any accumulated depreciation associated with it should also be removed.
- Profit or loss on disposal must be calculated.

CRH 2010 Q17: Where would you find the disposals of fixed assets in CRH's 2010 financial statements?
CRH 2010 Q17a: How much were the disposals of CRH's fixed assets in 2010?

2. Year-end adjusting entries

13. Property, Plant and Equipment

	Land and buildings €m	Plant and machinery €m	Transport	Assets in course of construction €m	Total €m
At 31st December 2008					
Cost/deemed cost	5,434	6,952	847	620	13,853
Accumulated depreciation (and impairment charges)	(1,113)	(3,385)	(467)	-	(4,965)
Net carrying amount	4,321	3,567	380	620	8,888
At 1st January 2008, net of accumulated depreciation					
Translation adjustment	61	8	13	(26)	56
Reclassifications of assets in course of construction	58	128	(4)	(182)	-
Additions at cost	141	413	71	414	1,039
Arising on acquisition (note 34)	218	179	20	12	429
Disposals at net carrying amount	(41)	(33)	(7)	-	(81)
Depreciation charge for year	(140)	(536)	(91)	-	(767)
Impairment charge for year	(6)	(8)	-	-	(14)
At 31st December 2008, net of accumulated depreciation (and impairment charges)	4,321	3,567	380	620	8,888

Accounting entries

Step ❶

Dr	Disposal a/c (Original asset cost)	X	
Cr	Asset account (Original cost)		X

Being the removal of the asset from the balance sheet

Step ❷

Dr	Accumulated depreciation	X	
Cr	Disposal account (Agg. Depreciation)		X

Being the removal of accumulated depreciation on asset to date of disposal from the balance sheet

Step ❸

Dr	Bank (Proceeds of sale of asset)	X	
Cr	Disposal Account (Proceeds)		X

Being receipt of proceeds for sale of fixed asset

Step ❹ (Calculate balance on disposal account)

Dr	P & L	X	
Cr	Disposal account		X

Being loss on disposal
(This last entry is reversed in the case of a profit)

2. Year-end adjusting entries

To summarise:

Disposal account						
1/12/20X1	Cost of fixed asset	50	1/12/20X1	Agg. Depreciation	30	● Transfer aggregate depreciation on fixed asset from aggregate depreciation account to disposal account
●	Transfer cost of fixed asset from fixed asset account to disposal account	<u>50</u>	1/12/20X1	Disposal proceeds	5	● Record cash received on disposal
			1/12/20X1	P/L account (loss)	<u>15</u>	● Calculate profit or loss on disposal
					<u>50</u>	

2.6 Bad debts and bad debt provisions

2.6.1 Bad debts

Some debtors of the company may not pay their debts due to bankruptcy, insolvency, receivership or disputes. An asset of the company should not be recorded in the balance sheet if it will not be collected or realised. Irrecoverable debtors must be written-off against profits.

When a bad debt is discovered the asset account must be reduced and the bad debt expense account increased. The total balance in the bad debts account goes to the profit and loss account.

Accounting entries

Dr.	Bad Debts Expense (profit and loss)	X	
Cr.	Debtors (balance sheet)		X

Being write-off of debtor

Example Ltd.

Total sales made during the year were €50 to A Ltd and €240 to B Ltd. Cash received from B Ltd on 30 November 20X1 amounted to €200. Bad debts are to be written-off for the year ended 31 December 20X1 as follows: A Ltd. €50; B Ltd. €40.

A Ltd (Debtors ledger account)					
20X1	Sales	<u>50</u>	31/12/X1	Bad debts	<u>50</u>

B Ltd (Debtors ledger account)					
20X1	Sales	240	30/11/X1	Cash	200
		<u> </u>	31/12/X1	Bad debts	<u>40</u>
		<u>240</u>			<u>240</u>

Debtors control account (Nominal ledger account)					
20X1	Sales	290	30/11/X1	Cash	200
		<u> </u>	31/12/X1	Bad debts	<u>90</u>
		<u>290</u>			<u>290</u>

Bad debts					
31/12/X1	A Ltd	50			
31/12/X1	B Ltd	<u>40</u>	31/12/X1	Profit & loss	<u>90</u>
		<u>90</u>			<u>90</u>

Charge in profit and loss account: Bad debts €90

2. Year-end adjusting entries

2.6.2 Provisions for bad debts

Based on past experience, managers know that there is a chance that some of the debts of the company may not be collected. A debtor which originates in year 1 may give rise to a specific bad debt in year 2. Unless bad debts are estimated each year:

- Net profit will be overstated
- Assets will be overstated

Bad debts are usually not known until the year following the sale. This gives rise to problems in applying the matching principle and in profit determination.

In accordance with the matching or accruals concept an estimate of bad debts expected to occur should be charged against the related revenue (i.e. the sale) rather than waiting for the actual bad debt to occur in the future. The charge will be an estimate. This estimate is called a *Provision* for any bad debts that may arise.

Similar to all year end adjusting entries, the estimate for provision for bad debts is only required when the business wishes to compute profits. At each year end, the estimated expense for bad debts not yet known (but likely because sales have been made) is calculated. This is called the provision for bad debts (or Provision for doubtful debts).

Thus, in the profit and loss account there are two charges for bad debts:

- Debts written-off as irrecoverable;
- Provision for any debt whose recovery is in doubt.

Example

Debtors are €150

You discover at the year-end date that Bloggs Ltd, which owes the company €20, has gone into liquidation with no hope of any recovery for creditors

The company's accounting policy is to make a provision for bad debts of 10% of debtors at the year end.

The two charges for debtors in the profit and loss account are:

- Debts written-off as irrecoverable - €20
- Provision for any debt whose recovery is in doubt €13 ($(150_{\text{Debtors}} - 20_{\text{Bloggs Ltd written off}}) @ 10\%$)

Thus, the total charge in the profit and loss account for bad debts is 33 ($20_{\text{bad debt written off}} + 13_{\text{increase in provision for bad debt}}$)

Debtors are shown in the balance sheet as:

Debtors 117 ($150_{\text{Debtors}} - 20_{\text{Bloggs Ltd written off}} - 13_{\text{Provision for bad debts}}$)

There are 2 methods of estimating bad debt provisions:

- Set provision at constant % gross debtors. The amount of the provision is usually a fixed (say 5%) percentage of total debtors
- Prepare a schedule ageing each debtor balance. The debtors figure might be broken down into subgroups depending on how long the debt is outstanding. Each subgroup total is then multiplied by a percentage depending on the management's assessment of the likelihood of bad debts.

Example

<u>Days Outstanding</u>	<u>Amount</u>
0 – 30	5,000
31 – 60	10,500
61 – 90	<u>3,500</u>
	<u>19,000</u>

2. Year-end adjusting entries

Under Method (A)

Take a fixed percentage say (5%) of total debtors i.e. $5\% \times 19,000 = \text{€}950$

Under Method (B)

<u>Days</u>	<u>Amount</u>	<u>Percent</u>	<u>Provision</u>
0 - 30	5,000	1%	50
31- 60	10,500	5%	525
61- 90	<u>3,500</u>	10%	<u>350</u>
	<u>19,000</u>		<u>925</u>

Companies in high risk businesses such as builders suppliers may make quite substantial bad debt provisions.

To increase / decrease bad debts provision (say increase)

Dr.	Bad debts expense (Increase: Nil _{Opening provision} – 950 _{Provision at end year 1})(P/L)	950
Cr.	Bad Debts Provision (Nil _{Opening balance} + 950 _{Increase} = 950 _{Closing balance}) (B/S)	950

Being increase in bad debts provision

Debtors in the balance sheet should be shown net of the provision for bad debts.

Current assets

Stock		20,000
Debtors	19,000	
Less: Provision for bad debts	<u>(950)</u>	18,050 etc.

Subsequent years - review provision.

Say, for example, that next year's provision is €1,025 (Closing debtors €20,500 @5%):

Dr.	Profit and loss account (Increase: 950 _{Provision year 1} – 1,025 _{Provision year 2})(P/L)	75
Cr.	Provision for bad debts (950 _{Opening balance} + 75 _{Increase} = 1,025 _{Closing balance}) (B/S)	75

Current assets

Stock		20,000
Debtors	20,500	
Less: Provision for bad debts	<u>(1,025)</u>	19,475 etc.

Say, for example, that the next year's provision is €850 (Closing debtors €17,000 @5%):

Dr.	Provision for bad debts (950 _{Opening balance} + 100 _{Decrease} = 850 _{Closing balance}) (B/S)	100
Cr.	Profit and loss account (Decrease: 950 _{Provision year 1} – 850 _{Provision year 2}) (P/L)	100

Current assets

Stock		20,000
Debtors	17,000	
Less: Provision for bad debts	<u>(850)</u>	16,150 etc.

2. Year-end adjusting entries

Example: To show interrelationship between bad debts and bad debt provisions

Year 1

Sales €10,000

Debtors at year end €10,000

Estimate that 5% of debtors will turn out to be bad

Dr	Bad debt expense (P/L)	500	
Cr	Bad debt provision (B/S)		500

Profit and loss account Year 1

Sales for year 1 10,000

Increase in bad debt provision 500

Profit for year 1 9,500

Balance sheet year 1

Current assets

Debtors 10,000

Provision for bad debts (500) 9,500

Profit and loss account 9,500

Year 2

Cash received €9,500

Actual bad debts €500

Profit and loss account Year 2

Decrease in bad debt provision (500)

Bad debts for year 500

Profit for year 2 Nil

Balance sheet year 2

Cash 9,500

P/L (year 1 retained profit carried forward) 9,500

Conclusion

- By creating a provision for bad debts in year 1, the bad debt expense was charged against year 1's revenue (sales) which gave rise to that expense;
- In year 2 the bad debt provision is available to be set against the actual bad debt expense when it arises such that there is no charge for bad debts in year 2's profit and loss account (the reduction in the provision and the actual bad debt expense cancel each other)
- It is difficult to see this relationship when there are many debtor balances and in a continuing business where there is roll-over of the provision from one year to the next.

Example

Year 1

Bad debts to be written-off: A Ltd €50; B Ltd €155

At year end debtors = €8,000

Decide €300 of the debtors would eventually turn out to be bad and provision should be made

		Bad debts			
Year 1	A Ltd.	50			
31/12	B Ltd.	<u>155</u>	31/12	P/L	<u>205</u>
		<u>205</u>			<u>205</u>

2. Year-end adjusting entries

Provision for bad debts					
31/12	Provision c/d	<u>300</u>	31/12	P/L	<u>300</u>

Expense in profit and loss account

Bad debts	205	
Provision for bad debts	<u>300</u>	505

Balance sheet

Debtors	8,000	
Less: Provision for bad debts	<u>(300)</u>	7,700

Year 2

Bad debts to be written-off: C Ltd. €196; R Ltd. €280; T Ltd. €70

At 31 December, debtors amounted to €11,000 of which €480 were doubtful.

Bad debts					
Year 2	C Ltd.	196			
	R Ltd.	280			
31/12	T Ltd.	<u>70</u>	31/12	P/L	<u>546</u>
		<u>546</u>			<u>546</u>

Provision for bad debts					
31/12	Provision c/d	480	1/1	Bal. b/d	300
		<u>480</u>	31/12	P/L	<u>180</u>
		<u>480</u>	1/1	Bal. b/d	<u>480</u>

Expense in profit and loss account

Bad debts	546	
Increase provision for bad debts	<u>180</u>	726

Balance sheet

Debtors	11,000	
Less: Provision for bad debts	<u>(480)</u>	10,520

Year 3

Bad debts to be written-off: L Ltd. €215; M Ltd. €196; P Ltd. €390

Debtors amounted to €10,200 at year end of which €410 might be doubtful

Bad debts					
Year 2	L Ltd.	215			
	M Ltd.	196			
31/12	N Ltd.	<u>390</u>	31/12	P/L	<u>801</u>
		<u>801</u>			<u>801</u>

Provision for bad debts					
31/12	P/L	70	1/1	Bal. b/d	480
31/12	Provision c/d	<u>410</u>			
		<u>480</u>	1/1	Bal. b/d	<u>410</u>

Expense in profit and loss account

Bad debts	801	
Decrease provision for bad debts	<u>(70)</u>	731

Balance sheet

Debtors	10,200	
Less: Provision for bad debts	<u>(410)</u>	9,790

3. Manufacturing Accounts

Section 3: Manufacturing Accounts
3.1 Differences between retailing and manufacturing businesses
3.1.1 Retail businesses
3.1.2 Manufacturing businesses
3.2 Manufacturing expense analysis in more detail
3.2.1 Examples of manufacturing expenses
3.3 Manufacturing account layout
3.4 Example manufacturing account

These notes deal with four aspects of manufacturing accounts:

- Differences between retail and manufacturing businesses
- Manufacturing expense analysis in more detail
- Manufacturing account layout
- Examples

3.1 Differences between retail and manufacturing businesses

3.1.1 Retail businesses

- Keep records of purchases (this is straightforward – take from purchase invoices)
- Count stock at year end
- Value stock at cost
- Compute cost of goods sold as follows:

Cost of sales	€
Opening stock	250
Purchases	<u>10,000</u>
Cost of goods available for sale	10,250
Less: Closing stock	(180)
Cost of goods sold	<u>10,070</u>

3.1.2 Manufacturing business

- Buy raw materials
- Convert into products using labour and other manufacturing overheads
- Sell products

Manufacturer cannot calculate *Cost of goods sold* as easily because s/he has to compute cost rather than taking it from invoices.

Needs to calculate:

1. Cost of goods produced in a year
2. Value of goods at year-end

Manufacturing accounts are used by management internally. They are not made public and can, therefore, be produced in any format. The primary function of manufacturing accounts is to calculate the production cost of finished goods manufactured (i.e., the equivalent of purchases in a retail business), which amount is transferred to the trading account to calculate gross profit.

3. Manufacturing Accounts

Note

Production cost of goods completed \neq Total production cost.

Total production cost is adjusted for opening and closing work-in-progress to obtain the production cost of goods completed.

The manufacturing account contains all the expenses pertaining to production (i.e. factory-related) whereas the profit and loss account contains the non-factory expenses such as administration, selling and distribution and financial expenses. The manufacturing account is mainly composed of expenses (Drs.), although a few production-related revenue items (Cr.s.) such as bulk/quantity discounts may be included. Note that sales invoices and purchase invoices tend to show bulk/quantity discounts. As a result, Sales and Purchases include any bulk/quantity discounts allowed (on sales) or received (on purchases). Discount allowed and received appearing in the trial balance, therefore, represent settlement (i.e., pay-on-time) discount. This discount is dealt with in the profit and loss account.

Apart from gross profit calculation, the manufacturing account aids management decision making so it should be presented and laid out in a manner that makes it most useful for decision-making purposes.

3.2 Manufacturing expense analysis in more detail

The manufacturing account calculates the production cost of goods completed during an account period. There are three main categories of cost/expense making up production cost:

- Direct material (i.e. raw material): Direct material costs are obtained by adjusting purchases of direct or raw materials for any opening and closing raw material stock.
- Direct labour (i.e. skilled craftsmen or conveyor belt employees working directly on units produced); and
- Factory overheads: Factory overheads include all indirect manufacturing costs such as indirect material, indirect labour, factory insurance, depreciation on factory plant and machinery.

In preparing manufacturing accounts expenses must be analysed between direct and indirect expenses and often between fixed and variable expenses.

Direct expenses are identifiable and traceable to particular units of production. Indirect expenses, although necessary for production, cannot be traced to or related to specific units produced.

Fixed expenses are fixed even if production varies. Variable expenses vary proportionately with production.

3.2.1 Examples of manufacturing expenses

The following expenses are analysed by way of example.

- | | |
|-------------------|--|
| Direct Materials | <ul style="list-style-type: none">• Purchase invoice• Carriage in• Duty on imported goods |
| Direct Labour: | <ul style="list-style-type: none">• Production operators |
| Direct Expense: | <ul style="list-style-type: none">• Levy per unit produced e.g. royalties |
| Factory Overhead: | <ul style="list-style-type: none">• Indirect Labour<ul style="list-style-type: none">▪ Factory supervisor▪ Factory fork-lift truck operator• Factory light and heat• Depreciation of factory machinery• Hire of fork-lift trucks in factory etc. |

3. Manufacturing Accounts

Factory overheads

All costs incurred in production other than raw materials and direct labour. Often based on apportionment.

Examples include:

- Indirect wages (e.g. Supervisor)
- Factory power
- Factory salaries
- Depreciation of factory
- Depreciation of machinery
- Repairs to machinery

Total production cost

Work in Progress (WIP)

- Cost incurred to date on production commenced but not completed.
- These items should be counted as stock at the year end.
- The stage of completion should be estimated (e.g. half completed)
- Adjust for opening and closing balances

Total production cost of goods completed

3.4 Example manufacturing account

Example Manufacturing Ltd		
Manufacturing Account		
Year Ended 31.12.20X1		
	€000	€000
Direct materials		
Opening stock raw materials	250	
Purchases	10,000	
Carriage/transport in	200	
Closing stock raw materials	<u>(180)</u>	
		10,270
Direct labour		<u>5,400</u>
Prime cost		15,670
Factory overhead		
Indirect factory wages	1,200	
Factory rent and rates	700	
Factory light and heat	430	
Depreciation on Plant & Machinery	<u>560</u>	
		2,890
Total manufacturing / production cost		18,560
Add: Opening work-in-progress		600
Less: Closing work-in-progress		<u>(800)</u>
Cost of manufacture of goods completed (to trading account)		<u>18,360</u>
Production cost of goods complete		

(Note: The manufacturing account will not be published)

3. Manufacturing Accounts

**Example Manufacturing Ltd
Trading Profit and Loss Account
for the year ending 31.12.20X1**

	€000	€000
Sales		23,000
Cost of sales		
Opening stock finished goods	1,700	
Cost of goods completed (Manufacturing account)	18,360	
Closing stock finished goods	<u>(1,400)</u>	
<i>Cost of goods sold</i>		<u>18,660</u>
Gross profit		4,340
Expenses		
<i>Distribution costs</i>		
Motor expenses	(850)	
Motor repairs	<u>(20)</u>	(870)
<i>Administration expenses</i>		
Clerical wages	(770)	
Office light and heat	(430)	
Office rent and rates	(260)	
Insurance	(130)	
Postage	(80)	
Sundry expenses	<u>(25)</u>	<u>(1,695)</u>
Net Profit/(Loss)		<u>1,775</u>

(Note: This profit and loss account will not be published – it contains too much detail)

**Example Manufacturing Ltd
Balance Sheet at 31.12.20X1**

	€000	€000	€000
Fixed assets	Premises	Plant and machinery	Total
Cost	2,500	4,320	6,820
Aggregate depreciation	<u>(520)</u>	<u>(1,390)</u>	<u>(1,910)</u>
Net book value	<u>1,980</u>	<u>2,930</u>	4,910
Current assets			
Stock (180 _{Raw Materials} +800 _{WIP} +1,400 _{Finished Goods})		2,380	
Debtors and Prepayments		3,250	
Cash at bank and on hand		<u>170</u>	
		<u>5,800</u>	
Current liabilities			
Creditors		(4,080)	
Bank overdraft		<u>(290)</u>	
		<u>(4,370)</u>	
Net current assets			<u>1,430</u>
Total assets less current liabilities			<u>6,340</u>
Capital and reserves			
Share capital			3,000
Profit and loss account brought forward		1,565	
Retained profit for the year		<u>1,775</u>	<u>3,340</u>
Profit and loss account carried forward			<u>6,340</u>

(Note: This balance sheet will not be published – it contains too much detail)

4. The annual report and published accounts

Section 4: The annual report and published accounts
4.1 Typical contents of annual reports
4.2 Overview of financial accounts
4.3 Overview of regulations
4.3.1 Statutory regulations relating to methods of accounting and disclosures
4.3.2 Professional accounting pronouncements
4.3.3 Stock Exchange rules

4.1 Typical contents of annual reports

Irish annual report formats are fairly standard, with some variation in sequence of topics. Typical annual report contents are summarised in the table below.

A considerable amount of the material at the start of annual reports is unregulated and provided voluntarily by companies. Examples of such material include:

- Results in brief/financial highlights
- Chairman's statements
- Chief executives' reports

Some material in annual reports is quasi-regulated. For example, the Stock Exchange's Combined Code on Corporate Governance is applicable on a comply-or-explain basis. Examples include:

- Corporate governance statements
- Directors' reports

Regulated material is often distinguished from earlier material by being on different quality paper. It includes:

- Auditors' reports
- Financial statements

Some material in financial statements is unregulated and produced voluntarily such as value added statements and historical financial summaries.

4. The annual report and published accounts

Group Financial Summary

(Figures prepared in accordance with Irish GAAP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
	€m	€m	€m	€m	€m	€m	€m	€m	€m	€m
Turnover including share of joint ventures	2,520	3,354	4,234	5,211	6,734	8,870	10,444	10,794	11,080	12,820
EBITDA (as defined)*	305	387	478	608	951	1,314	1,517	1,575	1,580	1,843
Group operating profit	224	283	349	442	676	919	1,020	1,049	1,046	1,247
Goodwill amortisation	-	-	-	(1)	(19)	(44)	(61)	(70)	(76)	(101)
Profit on disposal of fixed assets	1	1	9	11	7	13	17	16	13	11
Exceptional items	-	-	-	-	64	-	-	-	-	-
Profit on ordinary activities before interest	225	284	358	452	728	888	976	995	983	1,157
Net interest payable	(21)	(28)	(36)	(43)	(93)	(191)	(173)	(139)	(118)	(140)
Profit on ordinary activities before taxation	204	256	322	409	635	697	803	856	865	1,017
Taxation on profit on ordinary activities	(42)	(58)	(76)	(100)	(152)	(194)	(217)	(227)	(218)	(247)
Taxation on exceptional items	-	-	-	-	(20)	-	-	-	-	-
Profit on ordinary activities after taxation	162	198	246	309	457	503	586	629	647	770
Employment of capital										
Fixed assets										
- Tangible assets	895	1,236	1,519	2,288	3,226	4,551	5,150	5,004	5,145	5,320
- Intangible asset - goodwill	-	-	-	138	629	955	1,153	1,154	1,475	1,443
- Financial assets	118	127	132	53	66	104	316	275	349	702
Net working capital	(a)	133	255	313	512	608	915	1,040	1,078	1,116
Other liabilities	(b)	(25)	(36)	(72)	(306)	(449)	(487)	(495)	(457)	(440)
Total	1,121	1,582	1,892	2,685	4,080	6,038	7,164	7,054	7,643	8,269
Financed as follows										
Equity shareholders' funds	868	1,056	1,308	1,553	2,201	3,074	4,734	4,747	4,758	5,217
Preference share capital	1	1	1	1	1	1	1	1	1	1
Minority shareholders' equity interest	12	13	14	285	37	36	135	111	90	82
Deferred tax	49	70	104	116	172	307	400	485	486	528
Net debt	(c)	189	442	465	730	1,669	2,620	1,894	1,710	2,441
Convertible capital bonds	(d)	2	-	-	-	-	-	-	-	-
Total	1,121	1,582	1,892	2,685	4,080	6,038	7,164	7,054	7,643	8,269
Purchase of tangible assets	109	150	147	232	360	430	452	367	402	520
Acquisitions and investments	164	532	241	604	1,421	1,605	1,080	992	1,615	922
Total capital expenditure	273	682	388	836	1,781	2,035	1,532	1,359	2,017	1,442
Depreciation and goodwill amortisation	81	104	129	166	275	395	497	526	534	596
Earnings per share after goodwill amortisation (cent)	(e)	37.1	43.9	52.4	65.0	87.5	102.6	104.0	107.5	109.9
Earnings per share before goodwill amortisation (cent)	(e)	37.1	43.9	52.4	65.3	91.6	111.6	114.8	119.5	122.8
Dividend per share (cent)	(e)	9.49	10.64	12.21	14.08	16.43	18.73	20.74	22.90	25.34
Cash earnings per share (cent)	(e),(f)	55.9	67.1	80.2	100.3	145.4	184.0	192.7	198.2	201.4
Dividend cover (times)	(g)	3.9	4.1	4.3	4.6	5.3	5.5	5.0	4.7	4.3

Notes to Irish GAAP financial summary data

- (a) Excluding bank advances and cash and liquid investments which are included under net debt (see note (c) below).
- (b) Including deferred and contingent acquisition consideration due after more than one year and provisions for liabilities and charges and excluding deferred tax.
- (c) Net debt represents the sum of loans (including finance leases) and overdrafts falling due within one year, bank loans (including finance leases) falling due after more than one year less cash and liquid investments.
- (d) Including supplemental interest.
- (e) Per share amounts for 1995 to 2004 have been restated for the bonus element of the Rights Issue in March 2009.
- (f) Cash earnings per share equals the sum of profit for the year attributable to ordinary shareholders, depreciation and goodwill amortisation divided by the average number of Ordinary Shares outstanding for the year.
- (g) Excluding exceptional net gains in 1999.

4. The annual report and published accounts

Group Financial Summary

(Figures prepared in accordance with IFRS)

	Restated						
	2004 €m	2005 €m	2006 €m	2007 €m	2008 €m	2009 €m	2010 €m
Revenue	12,755	14,449	18,737	20,992	20,887	17,373	17,173
EBITDA (as defined)*	1,740	1,957	2,456	2,860	2,665	1,803	1,615
Group operating profit	1,220	1,392	1,767	2,086	1,841	955	698
Profit on disposals	11	20	40	57	69	26	55
Profit before finance costs	1,231	1,412	1,807	2,143	1,910	981	753
Finance costs	(264)	(297)	(407)	(473)	(503)	(419)	(380)
Finance revenue	118	138	155	170	160	122	133
Group share of associates' profit after tax	19	26	47	64	61	48	28
Profit before tax	1,104	1,279	1,602	1,904	1,628	732	534
Income tax expense	(232)	(273)	(378)	(466)	(366)	(134)	(95)
Group profit for the financial year	872	1,006	1,224	1,438	1,262	598	439
Employment of capital							
Non-current and current assets							
Property, plant and equipment	5,831	6,824	7,480	8,226	8,888	8,535	8,892
Intangible assets	1,774	2,252	2,966	3,692	4,108	4,095	4,305
Investments in associates/other financial assets	292	635	651	652	870	1,090	1,186
Net working capital	(h) 1,540	1,944	2,420	2,469	2,650	1,991	1,920
Other liabilities - current and non-current	(i) (1,048)	(1,255)	(1,109)	(880)	(1,140)	(1,096)	(1,111)
Total	8,389	10,400	12,408	14,159	15,376	14,615	15,192
Capital and reserves excluding preference share capital	4,944	6,194	7,062	7,953	8,086	9,636	10,327
Preference share capital	1	1	1	1	1	1	1
Minority interest	34	39	41	66	70	73	83
Net deferred income tax liability	652	718	812	976	1,128	1,182	1,308
Net debt	(j) 2,758	3,448	4,492	5,163	6,091	3,723	3,473
Total	8,389	10,400	12,408	14,159	15,376	14,615	15,192
Purchase of property, plant and equipment	551	652	832	1,028	1,039	532	466
Acquisitions and investments	1,019	1,298	2,311	2,227	1,072	458	567
Total	1,570	1,950	3,143	3,255	2,111	990	1,033
Depreciation of property, plant and equipment (including asset impairments)	516	556	664	739	781	794	786
Amortisation of intangible assets (including goodwill impairments)	4	9	25	35	43	54	131
Earnings per share after amortisation of intangible assets (including impairments) (cent)	(k) 147.5	168.3	202.2	236.9	210.2	88.3	61.3
Earnings per share before amortisation of intangible assets (including impairments) (cent)	(k) 148.1	170.0	206.5	242.7	217.4	96.3	79.9
Dividend per share (cent)	(k) 29.76	35.17	46.89	61.31	62.22	62.50	62.50
Cash earnings per share (cent)	(k),(l) 236.1	263.7	317.5	365.1	348.9	214.7	194.6
Dividend cover (times)	(m) 5.0	4.8	4.3	3.9	3.4	1.4	1.0

Notes to IFRS financial summary data

- (h) Represents the sum of inventories and trade and other receivables (included in current assets) less trade and other payables (included in current liabilities).
- (i) Represents the sum of current income tax liabilities, current and non-current provisions for liabilities, non-current trade and other payables and retirement benefit obligations.
- (j) Represents the sum of current and non-current interest-bearing loans and borrowings and derivative financial instrument liabilities less the sum of liquid investments, cash and cash equivalents and current and non-current derivative financial instrument assets.
- (k) Per share amounts for restated 2004 to 2008 have been restated for the bonus element of the Rights Issue in March 2009.
- (l) Cash earnings per share represents profit attributable to equity holders of the Company less preference dividends paid plus depreciation of property, plant and equipment, amortisation of intangible assets and, where applicable, asset impairments divided by the average number of Ordinary Shares outstanding for the year.
- (m) Represents earnings per Ordinary Share divided by dividends per Ordinary Share.

* Defined as earnings before interest, taxes, depreciation, amortisation, asset impairment charges, profit on disposals and the Group's share of associates' profit after tax.

4. The annual report and published accounts

Table 4.1: Typical contents of an annual report

Unregulated

Results in brief/financial highlights
Chairman's statement
Chief executive's report/Operating and financial review
Directors and other governance information

Regulated

Report of the directors
Auditors' report
Consolidated / group income statement / profit and loss account
Statement of changes in equity
Consolidated / group balance sheet
Parent company balance sheet
Consolidated cash flow statement
Accounting policies
Notes to the financial statements

Unregulated

Historical financial summary
Value added statement

4.2 Overview of financial accounts

Management accounts are prepared for use by management internally in an organisation. Financial accounts are prepared for external users:

- Investors
 - Shareholders
 - Potential shareholders
- Creditors
 - Banks
- Employees
 - (a) Statistical Data
 - (b) Plant Closure, Disposal, Acquisition
 - (c) Employment Costs
 - (d) Other 'non-wage' costs
 - (e) Names of recognised unions
 - (f) Health & safety
 - (g) Selected ratios
- Government
 - The Revenue
 - The Industrial Development Authority (IDA)
- General Public

The content and format of published financial information is governed by regulations and by requirements of the user. Regulatory agencies e.g. tax authorities specify the information to be submitted with tax returns; Industrial Development Authority (IDA) request certain documents in support of grant claims etc.

Draft accounts and published accounts differ in the level of detail provided. Published accounts contain the minimum information (generally) as required by regulations.

4. The annual report and published accounts

4.3 Regulations

The content and format of annual published financial accounts presented to shareholders in an annual report is determined by:

- The Companies Acts (including Directives of the EC)
- Professional accounting pronouncements; and
- The Stock Exchange (for listed companies).

4.3.1 Statutory regulations relating to methods of accounting and disclosures

There are a number of different types of registered company:

Private;
Public;
Limited;
Unlimited.

All registered companies must observe the requirements of the companies' acts.

The principal act is the Companies Act, 1963 (CA63).

The Companies Act, 1963 requires every company to keep proper books of account relating to:

- (a) receipts and payments
- (b) purchases and sales
- (c) assets and liabilities

such as will give a true and fair view of its affairs and explain its transactions.

Directors of a company must lay before shareholders at the annual general meeting each year a profit and loss account /income statement and balance sheet covering the period since the last account and made up to a date not more than nine months before the meeting.

CRH 2010 Q18a: Who are responsible for the financial accounts of a company?

CRH 2010 Q18b: What is the external auditors' responsibility for the financial accounts of a company?

4. The annual report and published accounts

Statement of Directors' Responsibilities

in respect of the financial statements

Company law in the Republic of Ireland requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Parent Company and of the Group and of the profit or loss of the Group for that period.

In preparing the Consolidated Financial Statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- comply with applicable International Financial Reporting Standards as adopted by the European Union, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

The considerations set out above for the Group are also required to be addressed by the Directors in preparing the financial statements of the Parent Company (which are set out on pages 106 to 109), in respect of which the applicable accounting standards are those which are generally accepted in the Republic of Ireland.

The Directors have elected to prepare the Parent Company's Financial Statements in accordance with generally accepted accounting practice in Ireland (Irish GAAP) comprising the financial reporting standards issued by the Accounting Standards Board and published by the Institute of Chartered Accountants in Ireland, together with the Companies Acts, 1963 to 2009.

The Directors are responsible for keeping proper books of account which disclose with reasonable accuracy at any time the financial position of the Parent Company and which enable them to ensure that the Consolidated Financial Statements are prepared in accordance with applicable International Financial Reporting Standards as adopted by the European Union and comply with the provisions of the Companies Acts, 1963 to 2009 and Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

4. The annual report and published accounts

Respective responsibilities of Directors and Auditors

The Directors are responsible for the preparation of the Consolidated Financial Statements in accordance with applicable Irish law and International Financial Reporting Standards ("IFRSs") as adopted by the European Union, and for the preparation of the Company Financial Statements in accordance with applicable Irish law and Accounting Standards issued by the Accounting Standards Board and promulgated by the Institute of Chartered Accountants in Ireland ("Generally Accepted Accounting Practice in Ireland") as set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Companies Acts, 1963 to 2009 and whether, in addition, the Consolidated Financial Statements have been properly prepared in accordance with Article 4 of the IAS Regulation. We also report to you our opinion as to: whether proper books of account have been kept by the Company; whether, at the balance sheet date, there exists a financial situation which may require the convening of an extraordinary general meeting of the Company; and whether the information given in the Directors' Report is consistent with the financial statements. In addition, we state whether we have obtained all the information and explanations necessary for the purposes of our audit and whether the Company Balance Sheet is in agreement with the books of account.

We also report to you if, in our opinion, any information specified by law or the Listing Rules of the Irish Stock Exchange regarding Directors' remuneration and other transactions is not disclosed and, where practicable, include such information in our Report.

We are required by law to report to you our opinion as to whether the description in the annual Corporate Governance Statement as incorporated by reference in the Directors' Report of the main features of the internal control and risk management systems in relation to the process for preparing the Consolidated Financial Statements is consistent with the Consolidated Financial Statements. In addition, we review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2008 Financial Reporting Council's Combined Code specified for our review by the Listing Rules of the Irish Stock Exchange, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' Report, the Chairman's Statement, the Chief Executive's Review, the Operations Reviews, the Finance Review and the Corporate Governance Statement. We consider the implications for our Report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

4. The annual report and published accounts

The financial statements are required to show a “*true and fair*” view. The company's auditors must carry out an annual audit and the auditor's opinion on the true and fair view must be included with the accounts (note that just because accounts show a true and fair view does not necessarily mean that the accounts are correct). In Ireland (other countries may have similar provisions) there is an audit exemption for small companies (i.e., Turnover < €317,435; Balance sheet total <€1.905 million; <50 employees; Not a parent or subsidiary; Up-to-date with filing obligations).

Companies (Amendment) Act 1986

The Companies Act, 1963 has been subject to a number of amendments, the most important of which, from a published financial accounts point of view, is the Companies (Amendment) Act, 1986 (CA86) implementing the EC 4th Directive on company accounts into Irish law. The object of the 4th Directive is to harmonise accounting practice and presentation in the accounts of EU companies.

The Companies (Amendment) Act, 1986 brings Irish company law into line with the requirements of the EC 4th Directive which lays down specific rules to be followed in presenting published accounting information in the EU.

The Companies (Amendment) Act, 1986 prescribes the layout and presentation to be followed in presenting accounts. The Act is very prescriptive and sets out 4 possible formats for the profit and loss account / income statement and 2 for the balance sheet.

Some guidance is given on how to account for certain transactions. Under the Companies (Amendment) Act, 1986, the published financial statements must be filed with the Registrar of Companies in Dublin Castle. The legislation originally did not apply to unlimited companies.

There is some relief from the disclosure provisions for small and medium sized companies (as defined in the legislation).

4.3.2 Professional accounting pronouncements

Accounting Standards

Accounting standards are authoritative statements of how particular types of transactions should be reflected in financial statements. Compliance with standards is necessary for accounts to give a '**True and Fair View**'. Accounting standards are statements on various accounting issues setting out:

- How transactions should be accounted for
- Disclosure in accounts

From 1970-1990 the regulatory body publishing accounting standards was the Accounting Standards Committee (ASC). The ASC published exposure drafts (EDs) of standards for comment and thereafter Statements of Standard Accounting Practice (SSAPs).

From 1990 a new regulatory body was established - the Accounting Standards Board (ASB). The ASB issues Financial Reporting Exposure Drafts (FREDs) and Financial Reporting Standards (FRSs).

SSAPs/FRSs aim to narrow the range of accounting practices and to make accounts more comparable. There are 25 SSAPs to date (not all of which continue to apply) and 29 FRSs.

From 2005, all EU listed companies are required to follow international accounting standards issued by the International Accounting Standards Board (IASB). The IASB issues International Financial Reporting Exposure Drafts (IFREDs) and International Financial Reporting Standards (IFRSs).

4.3.3 Stock Exchange rules

Stock Exchange rules apply to listed companies only. The listing agreement requires quoted companies to observe certain rules (contained in the “yellow book”/ “purple book”). These are some accounting disclosure requirements additional to company law and SSAP/FRS requirements.

4. The annual report and published accounts

CRH 2010 Q19: In relation to the 2010 annual report of CRH, what are its contents and how does it compare with the description above (in executing this requirement, please complete the following table)?

Table 4.1: Analysis of the contents of the CRH's annual report

CRH Annual report	Page
<i>Unregulated sections</i>	
<ul style="list-style-type: none">• Results in brief/financial highlights• Chairman's statement• Chief executive's report / Operating and financial review	
<i>Regulated sections</i>	
<ul style="list-style-type: none">• Directors and other information• Report of the directors	
CRH Financial statements	
<i>Regulated elements</i>	
<ul style="list-style-type: none">• Auditors' report• Consolidated income statement• Statement of changes in equity• Consolidated balance sheet• Parent company balance sheet• Consolidated cash flow statement• Accounting policies• Notes to the financial statements	
<i>Unregulated elements</i>	
<ul style="list-style-type: none">• Historical financial summary• Value added statement	

5. International Accounting Standards – Format of published accounts

Section 5: International Accounting Standards – Format of published accounts

- 5.1 Requirement to prepare accounts in accordance with international accounting standards
 - 5.1.1 EU Accounting harmonisation - Accounting Directives
 - 5.1.2 EU Accounting harmonisation – International accounting standards
 - 5.1.3 International Accounting Standards
 - 5.1.4 Introducing International Accounting Standards in the UK
 - 5.1.5 Introducing International Accounting Standards in the Republic of Ireland
 - 5.1.6 Irish legislation and International Accounting Standards
- 5.2 Accounting terminology in different jurisdictions
- 5.3 IAS 1 *Presentation of Financial Statements*
 - 5.3.1 Introduction
 - 5.3.2 Scope
 - 5.3.3 Purpose of financial statements
 - 5.3.4 Components of financial statements
 - 5.3.5 Overall considerations of IAS (para 13-41)
 - 5.3.6 Assumptions underlying financial statements
- 5.4 Illustrative structure of international financial statements
 - 5.4.1 Illustrative income statements
 - 5.4.2 Illustrative balance sheet
- 5.5 Notes to the financial statements
- 5.6 Disclosure of accounting policies
 - 5.6.1 Key sources of estimation uncertainty
 - 5.6.2 Other disclosures

Financial reporting is a highly regulated activity, regulated by legal and other regulations (the Rules). Different countries/bodies have implemented their own rules. These are not always consistent with each other.

5.1 Requirement to prepare accounts in accordance with international accounting standards

5.1.1 EU Accounting harmonisation – Accounting directives

In an attempt to harmonise accounting practice among EU countries, the European Commission published a number of documents, notably the Fourth Company Law Directive on the presentation of annual accounts and the Seventh Company Law Directive on group accounts. These directives have been adopted by EU countries in their national legislation. In Ireland, the Fourth Directive is legislated for in the Companies (Amendment) Act 1986. The Seventh Directive is legislated for in secondary legislation – The Group Accounts Regulations 1992. The directives have been successful in improving the comparability of accounts, thus facilitating cross-border business.

However, these Directives are not accepted as a basis for adequate financial reporting in major securities markets outside Europe. Consequently, in 1996, the European Commission put forward a new strategy to improve the financial reporting framework for European companies.

5.1.2 EU Accounting harmonisation – International Accounting Standards

The Commission's strategy is to associate the EU with the efforts of the International Accounting Standards Committee (IASC), now the International Accounting Standards Board (IASB) and IOSCO (International Organisation of Securities Commissions) with a view to EU companies preparing consolidated accounts in conformity with International Accounting Standards (IASs) / International Financial Reporting Standards (IFRSs) of the IASB.

The objectives of the new strategy are to promote:

5. International Accounting Standards – Format of published accounts

- Easier access for European companies in international capital markets;
- Improved comparability of consolidated accounts within the single European market.

5.1.3 International Accounting Standards

IASs / IFRSs influence accounts in two ways. Firstly, domestic/local standard-setters are increasingly attempting to produce standards that comply as much as possible with IASs/ IFRSs. Over recent years, there has been considerable cooperation between standard-setters across the world.

The UK Accounting Standards Board (ASB) has indicated its commitment to a strategy of gradual introduction of international standards into the UK. ASB's aim is to provide as smooth a path as possible for the transition from current UK standards to future IAS compliance. Consistent with this strategy, the ASB has issued some standards (e.g. FRS 20 *Share-based payment* (IFRS 2); FRS 21 *Events after the balance sheet date* (IAS 10)) entirely based on International Accounting Standards). In some cases, UK accounting standards are word-for-word the same as their IFRS counterpart. Consequently, with some exceptions, UK Generally Accepted Accounting Principles (GAAP) are consistent with IASs/ IFRSs.

Secondly, companies that are quoted on stock exchanges outside their own country may adopt international accounting standards to improve their acceptability in other jurisdictions. For example, the London Stock Exchange accepts from its registrants accounts prepared under IAS Generally Accepted Accounting Principles (GAAP). However, the New York Stock Exchange does not yet do so.

In June 2000, the European Commission issued a policy document proposing that all European companies listed on regulated markets (including banks and other financial institutions) should be required to prepare consolidated accounts in accordance with IASs/IFRSs, effective from 2005.

The requirement to use IASs/IFRSs applies only to the consolidated accounts of listed companies. However, the Commission permits Member States to require or to allow unlisted companies to publish financial statements in accordance with the same set of standards as those for listed companies.

In June 2002 the EU formally adopted the International Accounting Standards (IAS) Regulation. This Regulation requires all EU companies listed on a regulated market to present their consolidated accounts in accordance with IASs/IFRSs from 2005. Unlike directives, EU Regulations have the force of law without requiring transposition into national legislation. Member States have the option of extending the requirements of this Regulation to unlisted companies and to parent company individual accounts.

5.1.4 Introducing International Accounting Standards in the UK

The UK Department of Trade and Industry allows unlisted companies and unlisted groups to choose to comply with either IFRSs or UK standards. IFRSs are mandatory for the group accounts of listed companies. Holding companies and subsidiaries of listed groups may choose to adopt IFRSs or UK FRSs in their individual company accounts. However, once a company has chosen to adopt IFRSs it will not subsequently be allowed to revert to UK standards.

5.1.5 Introducing International Accounting Standards in the Republic of Ireland

Accounting standards developed in UK by the Accounting Standards Board (ASB) are promulgated in Ireland through the Institute of Chartered Accountants in Ireland. Thus, UK generally accepted accounting principles (GAAP) are similar in almost all respects to Irish GAAP.

The new Companies (Auditing and Accounting) Act 2003 indicates that the Minister for Enterprise, Trade and Employment will have the power to authorise by regulation the bodies that issue accounting standards. This is to facilitate authorisation of the International Accounting Standards Board, thus allowing International Accounting Standards (IASs) / International Financial Reporting Standards (IFRSs) to apply to Irish publicly-listed companies (at least).

5. International Accounting Standards – Format of published accounts

In May 2004 the Irish Government indicated that all companies (listed and unlisted) will be permitted to apply international standards from 2005 onwards.

5.1.6 Irish legislation and International Accounting Standards

Statutory instrument 116 of 2005 *European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005* introduced International Accounting Standards into Irish law.

This allows for Companies Act individual accounts or IFRS individual accounts.

Listed companies must use IFRSs from 1/1/2005. Other companies have a one way choice (i.e. can't change their minds) between adopting IFRSs or Irish legislation, unless circumstances change

Consistency of treatment is required within groups of companies.

These regulations also introduce some of the requirements of IAS 1 *Presentation of Financial Statements* into Irish law.

For example, introducing some requirements of IAS 1, statutory instrument 116 of 2005 requires:

- Reconciliation of profit and loss movements previously shown on face of the profit and loss account / income statement (A reconciliation is an explanation of changes in balances expressed in numerical terms of why one balance (often the opening balance) changed into another balance (often the closing balance))
- Reconciliation of profit and loss movements now to be shown as a note
 - ◆ Dividends paid
 - ◆ Transfers between profit and loss account reserve and other reserves
 - ◆ Profit for year
 - ◆ Balance bought forward
 - ◆ Balance carried forward
- Dividends proposed no longer to be recognised in accounts
- Dividends proposed to be disclosed in notes

5. International Accounting Standards – Format of published accounts

5.2 Accounting terminology in different jurisdictions

Accounting terms vary slightly between UK/Irish GAAP, US GAAP and IAS GAAP, as illustrated below.

UK & Ireland	US	IAS
<ul style="list-style-type: none"> • Turnover • Profit & Loss account 	<ul style="list-style-type: none"> • Sales (or revenue) • Income statement 	<ul style="list-style-type: none"> • Sales (or revenue) • Income statement
<ul style="list-style-type: none"> • Fixed Assets • Tangible fixed assets • Stock • Debtors • Shareholders' funds • Shares • Creditors: Amounts falling due within one year • Creditors: Amounts falling due after more than one year • Long term liabilities • Creditors 	<ul style="list-style-type: none"> • Non-current assets • Inventory • Receivables • Stock • Payables 	<ul style="list-style-type: none"> • Non-current assets • Property, plant and equipment • Inventory • Receivables • Equity • Shares • Current liabilities • Non-current liabilities • Non-current liabilities • Payables
<ul style="list-style-type: none"> • Acquisition • Merger 	<ul style="list-style-type: none"> • Purchase • Pooling of interests 	<ul style="list-style-type: none"> • Acquisition • Uniting of interests

CRH 2010 Q20: In relation to the above terms, which terms does CRH use in its 2010 financial statements?

5.3 IAS 1 *Presentation of Financial Statements*

5.3.1 Introduction

IAS 1 *Presentation of Financial Statements* was issued in December 2003 and is applicable for annual periods beginning on or after 1 January 2005.

IAS 1 prescribes the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.

5.3.2 Scope (para 2)

IAS 1 applies to general purpose financial statements prepared and presented in accordance with international financial reporting standards (IFRSs).

IAS 1 does not apply to interim financial statements prepared in accordance with IAS 34 *Interim Financial Reporting*.

5.3.3 Purpose of financial statements (para 7)

To provide information about the ① financial position, ② performance and ③ cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

Financial statements also show the results of management's stewardship of the resources entrusted to it.

Financial statements provide information about:

- Assets

5. International Accounting Standards – Format of published accounts

• Liabilities		Balance sheet
• Equity		
• Income and expenses		Income statement
• including gains and losses		Statement of changes in equity
• Other changes in equity		Statement of changes in equity
• Cash flows		Cash flow statement

Financial statements assist users in predicting the enterprise's future cash flows –
① timing, and ② certainty

5.3.4 Components of financial statements (para 8-10)

- Balance sheet
- Income statement
- Statement of changes in equity
 - ◆ All changes **or**
 - ◆ Changes, other than those with equity holders
- Cash flow statement
- Notes comprising significant accounting policies and other explanatory notes

Companies are also encouraged to present a financial review which:

- Describes and explains the main features of ① financial performance and ② financial position and the ③ principle uncertainties enterprise faces
- Reviews the main factors and influences determining performance
 - ◆ Changes in the operational environment
 - ◆ Enterprise's responses (and their effect) to changes in the operational environment
 - ◆ Policy for investment to maintain and enhance performance, including dividend policy
- Disclose ① Sources of funding, ② policy on gearing, ③ risk management policies
- Disclose resources not recognised in the balance sheet

Companies are also encouraged to present additional statements

- Environmental reports (especially where environmental issues are important)
- Value added statements (especially when employees are considered to be an important user group)

5.3.5 Overall considerations of IAS (para 13-41)

A complete set of financial statements comprises a balance sheet; an income statement; a statement of changes in equity (see Section 6 of these notes); a cash flow statement; and notes, comprising a summary of significant accounting policies and other explanatory notes.

- Financial statements present fairly the financial position, financial performance and cash flows of an entity.
- Fair presentation requires faithful representation of the effects of transactions, events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out the *Framework for the Preparation and Presentation of Financial Statements*.
- Application of IFRSs (i.e., Standards and Interpretations), with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.
- An entity makes an explicit and unreserved statement of compliance with IFRSs in the notes to the financial statements. Such a statement is only made on compliance with all the requirement of IFRSs.
- A departure from IFRSs is acceptable only in the extremely rare circumstances in which compliance with IFRSs conflicts with providing information useful to users in making economic decisions.
- IAS 1 specifies the disclosures required when an entity departs from a requirement of an IFRS.

CRH 2010 Q21: Find the statement of compliance in CRH 2010 financial statements?

5. International Accounting Standards – Format of published accounts

Compliance

In the period under review, CRH complied with the provisions set out in Section 1 of the 2008 Combined Code. The Company also complied with the rules issued by the United States Securities and Exchange Commission to implement the Sarbanes-Oxley Act 2002, in so far as they apply to the Group.

5.3.6 Assumptions underlying financial statements

Section 4 of the Companies (Amendment) Act 1986 does not permit set off between assets, liabilities, income, expenditure.

Section 5 of the Companies (Amendment) Act 1986 identifies four principles as follows:
The fundamental accounting principles (valuation rules) to be followed under Irish company law are:

- Going concern
- Accounting policies to be applied consistently from year to year.
- Prudence
(i.e. Include only realised profit. Realised profit is defined by the Act (The Schedule Part VII para. 72) as those profits which fall to be treated as realised in accordance with generally accepted accounting principles. Account for all liabilities and losses including those becoming apparent between the date of the accounts and the date of their approval.)
- All income/charges should be taken into account without regard to the date of receipt/payment.

Due to abuses of the prudence principle, this accounting principle has been dropped / demoted in IAS 1. IAS 1 requires observance of seven accounting principles which are described below.

1. Going concern

Financial statements are prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. (Paragraph 23, IAS 1)

2. Accrual basis of accounting

Financial statements, except for cash flow information, are prepared using the accrual basis of accounting. (Paragraph 25, IAS 1)

3. Consistency of presentation

The presentation and classification of items in the financial statements are usually retained from one period to the next. (Paragraph 27, IAS 1)

4. Materiality and aggregation

Each material class of similar items is presented separately. Dissimilar items are presented separately unless they are immaterial. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. (Paragraph 29, IAS 1)

5. Offsetting

Assets and liabilities, and income and expenses, are not offset unless required or permitted by an IFRS. (Paragraph 32, IAS 1)

6. Comparative information

5. International Accounting Standards – Format of published accounts

Comparative information is disclosed for all amounts reported in the financial statements, unless an IFRS requires or permits otherwise. (Paragraph 36, IAS 1)

7. Reporting period

Financial statements are presented at least annually. (Paragraph 49, IAS 1)

- IAS 1 specifies the minimum line item disclosures on the face of, or in the notes to, the balance sheet, the income statement, and the statement of changes in equity (see Section 6 of these notes).
- Current and non-current assets, and current and non-current liabilities are presented as separate classifications on the face of the balance sheet.
- IAS 1 specifies disclosures about information to be presented in the financial statements, including judgments, key sources of estimation uncertainty, and accounting policies.

5.4 Illustrative structure of international financial statements

The following illustrations of the structure of financial statements are taken from the guidance on implementing IAS 1.

5.4.1 Illustrative income statements (Appendix, IAS 1)

Two income statements are provided, to illustrate the alternative classifications of income and expenses:

- (i) By function (called “operational format” in Irish legislation). This is the most common format applied in practice.
- (ii) By nature (called “type of expenditure format” in Irish legislation).

Income statement for the year ended 31 December 20X2 (illustrating the classification of expenses by function format)

	20X2	20X1
	€000	€000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates*	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the period	X	X
Attributable to:		
- Equity holders of the parent	X	X
- Minority interest	X	X
	X	X

*This means the share of associates’ profit attributable to equity holders of the group, i.e., it is after tax and minority interests in the associates.

The caption “Other income” includes operating income and non-operating income. Operating items of income and expenditure are those revenues and expenses from the company’s own operations.

Examples of non-operating income/expenditures include dividend income from investments, profit on

5. International Accounting Standards – Format of published accounts

sale of shares in other companies, losses on value of investments, foreign exchange losses, write down of assets.

Operating earnings can be defined as revenue after cost of goods sold, distribution costs, administration expenses, other operating costs, before interest and before taxes. Net profit before interest and taxes is sometimes abbreviated to EBIT (Earnings Before Interest and Taxes). Operating profit is the profit from core operations of the business.

Items in the income statement can be shown in the notes to the accounts rather than on the face of the income statement. Thus, some line items in the illustrative examples in IAS 1 may appear in the notes to the accounts.

Income statement for the year ended 31 December 20X2 (illustrating the classification of expenses by nature format)

	20X2 €000	20X1 €000
Revenue	X	X
Other income	X	X
Changes in inventories of finished goods and work in progress	(X)	X
Work performed by the entity and capitalised	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation and amortisation expense	(X)	(X)
Impairment of property, plant and equipment*	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	<u>X</u>	<u>X</u>
Income tax expense	(X)	(X)
Profit for the period	<u><u>X</u></u>	<u><u>X</u></u>
Attributable to:		
- Equity holders of the parent	X	X
- Minority interest	X	X
	<u><u>X</u></u>	<u><u>X</u></u>

* In an income statement in which expenses are classified by nature, an impairment of property, plant and equipment is shown as a separate line item. By contrast, if expenses are classified by function, the impairment is included in the function(s) to which it relates.

Q: Re-present the profit and loss account of Example Limited shown on page 8 of these notes, in a format that complies with IAS 1 *Presenting Financial Statements*

5. International Accounting Standards – Format of published accounts

CRH 2010 Q22: Which of the two income statement formats does CRH adopt in its 2010 financial statements?

CRH 2010 Q23: Identify five differences between the above illustrative income statements and CRH's income statement in its 2010 financial statements?

Consolidated Income Statement

for the financial year ended 31 December 2010

		2010 €m	2009 €m
Notes			
1	Revenue	17,173	17,373
3	Cost of sales	(12,363)	(12,510)
	Gross profit	4,810	4,863
3	Operating costs	(4,112)	(3,908)
1,4,6	Group operating profit	698	955
1,5	Profit on disposals	55	26
	Profit before finance costs	753	981
9	Finance costs	(380)	(419)
9	Finance revenue	133	122
10	Group share of associates' profit after tax	28	48
1	Profit before tax	534	732
11	Income tax expense	(95)	(134)
	Group profit for the financial year	439	598
	Profit attributable to:		
	Equity holders of the Company	432	592
	Non-controlling interests	7	6
	Group profit for the financial year	439	598
13	Basic earnings per Ordinary Share	61.3c	88.3c
13	Diluted earnings per Ordinary Share	61.2c	87.9c

All of the results relate to continuing operations.

5. International Accounting Standards – Format of published accounts

5.4.2 Illustrative balance sheet (Appendix IAS 1)

The illustrative balance sheet shows one way in which a balance sheet distinguishing between current and non-current items may be presented. Other formats may be equally appropriate, provided the distinction is clear.

Balance sheet as at 31 December 20X2

	20X2	20X1
	€000	€000
<u>Assets</u>		
Non-current assets		
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
Investments in associates	X	X
Available-for-sale investments	X	X
	<u>X</u>	<u>X</u>
Current assets		
Inventories	X	X
Trade receivables	X	X
Other current assets	X	X
Cash and cash equivalents	X	X
	<u>X</u>	<u>X</u>
Total assets	<u>X</u>	<u>X</u>
	20X2	20X1
	€000	€000
<u>Equity and Liabilities</u>		
Equity attributable to equity holders of the parent		
Share capital	X	X
Other reserves	X	X
Retained earnings	X	X
	<u>X</u>	<u>X</u>
Minority interest	<u>X</u>	<u>X</u>
Total equity	<u>X</u>	<u>X</u>
Non-current liabilities		
Long-term borrowings	X	X
Deferred tax	X	X
Long-term provisions	X	X
Total non-current liabilities	<u>X</u>	<u>X</u>
Current liabilities		
Trade and other payables	X	X
Short-term borrowings	X	X
Current portion of long-term borrowings	X	X
Current tax payable	X	X
Short-term provisions	X	X
Total current liabilities	<u>X</u>	<u>X</u>
Total liabilities	<u>X</u>	<u>X</u>
Total equity and liabilities	<u>X</u>	<u>X</u>

5. International Accounting Standards – Format of published accounts

Some disclosures are specifically required to be shown on the face of the balance sheet, rather than in the notes to the balance sheet. The main items to be presented on the face of balance sheet include (× = not included in IAS 1 illustrative balance sheet above):

- Property plant and equipment✓
- Investment property×
- Intangible assets✓
- Financial assets✓
- Investments under equity method of accounting✓
- Inventories✓
- Trade and other receivables✓
- Cash and cash equivalents✓
- Trade and other payables✓
- Provisions✓
- Financial liabilities✓
- Liabilities and assets for current tax✓
- Deferred tax liabilities and assets✓
- Minority interest✓
- Issued capital and reserves✓

Q: Re-present the balance sheet of Example Limited shown on page 5 of these notes, in a format that complies with IAS 1 *Presenting Financial Statements*

5. International Accounting Standards – Format of published accounts

CRH 2010 Q24: Identify five differences between the above illustrative balance sheet and CRH's balance sheet in its 2010 financial statements?

Consolidated Balance Sheet

as at 31 December 2010

Notes	2010 €m	2009 €m
ASSETS		
Non-current assets		
14	8,892	8,535
15	4,305	4,095
16	1,037	962
16	149	128
24	194	244
27	385	337
	14,962	14,301
Current assets		
17	2,187	2,008
18	2,419	2,454
	112	77
24	14	5
22	37	66
22	1,730	1,372
	6,499	5,982
	21,461	20,283
EQUITY		
Capital and reserves attributable to the Company's equity holders		
29	244	241
29	1	1
29	3,915	3,778
29	(199)	(279)
	147	128
	(226)	(740)
	6,446	6,508
	10,328	9,637
	83	73
	10,411	9,710
LIABILITIES		
Non-current liabilities		
23	4,695	4,943
24	33	78
27	1,693	1,519
19	163	167
28	474	454
26	253	240
	7,311	7,401
Current liabilities		
19	2,686	2,471
	199	192
23	666	381
24	54	8
26	134	120
	3,739	3,172
	11,050	10,573
	21,461	20,283

5. International Accounting Standards – Format of published accounts

IAS 1 requires the following items to be presented on the face of balance sheet (✗ = not included in IAS 1 illustrative balance sheet)

- Property plant and equipment ✓
- Investment property ✗
- Intangible assets ✓
- Financial assets ✓
- Investments under equity method of accounting ✓
- Inventories ✓
- Trade and other receivables ✓
- Cash and cash equivalents ✓
- Trade and other payables ✓
- Provisions ✓
- Financial liabilities ✓
- Liabilities and assets for current tax ✓
- Deferred tax liabilities and assets ✓
- Minority interest ✓
- Issued capital and reserves ✓

5.5 Notes to the financial statements (para 103-107, IAS 1)

The notes shall:

- (a) present information about the basis of preparation of the financial statements and the specific accounting policies used in accordance with paragraphs 108-115 of IAS 1;
- (b) disclose the information required by IFRSs that is not presented on the face of the balance sheet, income statement, statement of changes in equity (see Section 6 in these notes) or cash flow statement (see Section 9 in these notes); and
- (c) provide additional information that is not presented on the face of the balance sheet, income statement, statement of changes in equity (see further on in these notes) or cash flow statement, but is relevant to an understanding of any of them.

Notes shall, as far as practicable, be presented in a systematic manner. Each item on the face of the balance sheet, income statement, statement of changes in equity (see Section 6 in these notes) and cash flow statement (see Section 9 in these notes) shall be cross-referenced to any related information in the notes.

Notes are normally presented in the following order, which assists users in understanding the financial statements and comparing them with financial statements of other entities:

- (a) a statement of compliance with IFRSs;
- (b) a summary of significant accounting policies applied;
- (c) supporting information for items presented on the face of the balance sheet, income statement, statement of changes in equity (see Section 6 of these notes) and cash flow statement, in the order in which each statement and each line item is presented; and
- (d) other disclosures, including:
 - (i) contingent liabilities¹ (see IAS 37) and “unrecognised” contractual commitments²; and
 - (ii) non-financial disclosures, e.g., the entity’s financial risk management objectives and policies (see IAS 32).

¹ Contingent liabilities are those that are dependent on the outcome of some future event, e.g., outcome of a court case, guarantor for a loan (only called up if borrower defaults on loan).

² “Unrecognised” means not recorded by double entry, i.e., not recorded in the income statement or balance sheet.

5. International Accounting Standards – Format of published accounts

CRH 2010 Q25: How many notes to its accounts does CRH disclose in its 2010 financial statements?

Independent Auditors' Report

to the members of CRH public limited company

We have audited the Consolidated and Parent Company ("Company") Financial Statements (the "financial statements") of CRH plc for the year ended 31 December 2010 which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated and Company Balance Sheets, the Consolidated Statement of Changes in Equity, the Consolidated Statement of Cash Flows, the related notes 1 to 33 (Group) and the related notes 1 to 12 (Company). These financial statements have been prepared under the accounting policies set out therein.

5.6 Disclosure of accounting policies (para 107-115, IAS 1)

An entity shall disclose in the summary of significant accounting policies:

- (a) the measurement basis (or bases) used in preparing the financial statements; and
- (b) the other accounting policies used that are relevant to an understanding of the financial statements.

It is important for users to be informed of the measurement basis or bases used in the financial statements (for example, historical cost, current cost, net realisable value, fair value or recoverable amount) because the basis on which the financial statements are prepared significantly affects their analysis. When more than one measurement basis is used in the financial statements, for example when particular classes of assets are revalued, it is sufficient to provide an indication of the categories of assets and liabilities to which each measurement basis is applied.

An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations management has made in the process of applying the entity's accounting policies, that have the most significant effect on the amounts recognised in the financial statements.

An accounting policy may be significant for some companies but not others. For example, the bad debt accounting policy is not significant for most companies and is therefore usually not disclosed in the list of significant accounting policies. An exception is financial institutions, where bad debts are one of their largest costs.

CRH 2010 Q26: How many accounting policies does CRH disclose in its 2010 financial statements?

5.6.1 Key sources of estimation uncertainty (para 116-124, IAS 1)

An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

- (a) their nature; and
- (b) their carrying amount as at the balance sheet date.

CRH 2010 Q27: Identify five estimation uncertainty disclosures in the accounting policies of CRH in its 2010 financial statements?

5. International Accounting Standards – Format of published accounts

Key Accounting Policies which involve Estimates and Assumptions

The preparation of the Consolidated Financial Statements in accordance with IFRS requires management to make certain estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Management believes that the estimates and assumptions upon which it relies are reasonable based on the information available to it at the time that those estimates and assumptions are made. In some cases, the accounting treatment of a particular transaction is specifically dictated by IFRS and does not require management's judgement in its application.

The critical accounting policies which involve significant estimates or assumptions, the actual outcome of which could have a material impact on the Group's results and financial position, are:

5.6.2 Other disclosures (para 125-126, IAS 1)

An entity shall disclose in the notes:

- (a) the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to equity holders during the period, and the related amount per share; and
- (b) the amount of any cumulative preference dividends not recognised.

An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

- (a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);
- (b) a description of the nature of the entity's operations and its principal activities; and
- (c) the name of the parent and the ultimate parent of the group.

CRH 2010 Q28: What does CRH disclose in respect of each of the other disclosure items (a), (b), (c) above in its 2010 financial statements?

Dividends proposed (memorandum disclosure)

Equity

Final 2010 - proposed 44.00c per Ordinary Share (2009: 44.00c)

312

307

Accounting Policies

(including key accounting estimates and assumptions)

Statement of Compliance

The Consolidated Financial Statements of CRH plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union, which comprise standards and interpretations approved by the International Accounting Standards Board (IASB). IFRS as adopted by the European Union differ in certain respects from IFRS as issued by the IASB. However, the Consolidated Financial Statements for the financial years presented would be no different had IFRS as issued by the IASB been applied. References to IFRS hereafter should be construed as references to IFRS as adopted by the European Union.

CRH plc, the parent company, is a publicly traded limited company incorporated and domiciled in the Republic of Ireland.

Subsidiaries, joint ventures and associates

The Consolidated Financial Statements include the financial statements of the Company (CRH plc, the ultimate parent) and its subsidiaries, joint ventures and associates as documented in the accounting policies on pages 60 to 66. The Group's principal subsidiaries, joint ventures and associates are disclosed on pages 114 to 121.

6. Statement of changes in equity

Section 6: Statement of changes in equity

- 6.1 IAS 1 – Statement of changes in equity
- 6.2 Two approaches to statement of changes in equity
- 6.3 Requirements of IAS 1 concerning statement of changes in equity
- 6.4 Examples

International Accounting Standard 1 (IAS 1) *Presentation of Financial Statements* requires full disclosure of changes in equity. Changes in equity / shareholders' funds can be expressed in a number of ways:

- Equity = Share capital and Reserves
- Equity = Share capital, Capital reserves (i.e., non-distributable) and Revenue reserves (i.e., distributable)
- Equity = Share capital, Share premium, Revaluation reserves, Translation reserves and Retained earnings

Changes in equity are disclosed mostly in the Income Statement with some changes in equity included in the Statement of Changes in Equity. Both the Income Statement and the Statement of Changes in Equity are primary statements.

- Dividends are not shown on the Income Statement, but instead are shown in the Statement of Changes in Equity.
- Preference dividends are shown as interest
- Equity balances brought forward (i.e. opening balances) and carried forward (i.e. closing balances) are not shown on the income statement, but instead are shown in the Statement of Changes in Equity.

6.1 Requirements of IAS 1 concerning statement of changes in equity

IAS 1 requires all gains and losses to be shown in the income statement, unless a specific standard states otherwise (comprehensive [“one-stop-shop”] income approach). When the standards permit, then the gain or loss must be shown in the statement of changes in equity. Examples include revaluation/devaluation gains/losses; and foreign currency translation gains/losses.

The accounting standards limit and control the nature of reserve movements by insisting that only a limited number of prescribed items may be accounted for directly through reserves (i.e., directly in equity). This ensures that all except a very few transactions (including any unusual / exceptional items) must hit the “bottom line” in the income statement. Reserve accounting is not always transparent. The purpose of the statement of changes in equity is to enhance transparency by ensuring that full disclosure is made of all gains and losses made in the period which have not gone through the income statement, and which have been dealt with directly in reserves.

The statement of changes in equity shows separately the components of shareholders' equity, such as share capital, share premium account, revaluation reserves, translation reserves and retained earnings. Minority interests in subsidiaries must be shown separately from equity holders' interests in these balances.

The statement of changes in equity starts by showing the balances on these accounts at the beginning of the accounting period. Then the changes in each balance are itemised. Finally the statement finishes with the closing balances. Shareholders' equity is thus reconciled from one balance sheet to the next. Full comparatives are provided. (A reconciliation is an explanation of changes in balances expressed in numerical terms of why one balance (often the opening balance) changed into another balance (often the closing balance)).

Following the requirements of IAS 1 *Presentation of Financial Statements*, an entity shall present, as a

6. Statement of changes in equity

primary statement, a statement of changes in equity showing on the face of the statement:

- (1) profit or loss for the period;
- (2) each item of income and expense for the period that, as required by other Standards or by Interpretations, is recognised directly in equity, and the total of these items;
- (3) total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to equity holders of the parent and to minority interest; and
- (4) for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with IAS 8.

An entity shall also present, either on the face of the statement of changes in equity or in the notes:

- (5) the amounts of transactions with equity holders acting in their capacity as equity holders, showing separately distributions to equity holders;
- (6) the balance of retained earnings (i.e., accumulated profit or loss) at the beginning of the period and at the balance sheet date, and the changes during the period; and
- (7) a reconciliation between the carrying amount of each class of contributed equity and each reserve at the beginning and the end of the period, separately disclosing each change.

Changes in an entity's equity between two balance sheet dates reflect the increase or decrease in its net assets during the period. This arises because of the balance sheet equation:

$$\text{Assets} - \text{Liabilities (i.e. net assets)} = \text{Equity}$$

If net assets increase, then equity has to increase by the same amount, otherwise the balance sheet will not balance.

Except for changes resulting from transactions with equity holders acting in their capacity as equity holders (such as equity contributions, re-acquisitions of the entity's own equity instruments and dividends) and transaction costs directly related to such transactions, the overall change in equity during a period represents the total amount of income and expenses, including gains and losses, generated by the entity's activities during that period (whether those items of income and expenses are recognised in profit or loss or directly as changes in equity).

Thus, equity changes for three broad reasons:

1. The entity generates net realised profit/losses, which increases/decreases equity
2. The entity has net unrealised gains/losses, which increases/ decreases equity
3. The shareholders contribute more/less capital, or receive dividends

To summarise, changes in equity

- Disclose
 - ◆ Profit/loss for period
 - ◆ Each item of income, expense, recognised directly in equity (reserve accounting)
 - ◆ Cumulative effect of changes in accounting policy and correction of errors under IAS 8
- In addition, disclose
 - ◆ Transactions with equity holders, distributions to equity holders
 - ◆ Opening profit b/f (brought forward), Closing profit c/f (carried forward), changes thereon for period
 - ◆ Reconciliation opening and closing balance for each class of equity capital, share premium, reserve, with each change disclosed

6. Statement of changes in equity

6.2 Two approaches to statement of changes in equity

IAS 1 requires the following format to be applied to the statement of changes in equity:

Lines 1-4 must be shown on the face of the statement of changes in equity. These are broadly the gains and losses made by the entity during the period, and their totals

1. Profit or loss for the period
2. Specific gains and losses required to be shown here by the standards (e.g. gains and losses on revaluation/devaluation of assets, on retranslation of the net assets of foreign subsidiaries, and the tax on such items shown as a separate line)
3. Total income and expense for the period (calculated as the sum of 1 and 2) described as “*Total recognised income and expense for the period*”
4. Effects of changes in accounting policy and errors as prescribed by IAS 18 (not relevant to the MBA course)

Lines 5-7 may be stated on the face of the statement of changes in equity or by way of a note. These broadly cover the entity’s transactions with its equity holders, and their totals:

5. Transactions with equity holders showing distributions separately (e.g. issues of shares). Dividends have to be separated out. You should note that only dividends declared by the balance sheet date should be accounted for here, any declared afterwards must be disclosed in the notes, but may not be shown here (IAS 10 para. 12).
6. Opening balance on retained earnings account (also known as accumulated profit and loss and Reserves) and the changes in the period, and the closing balance
7. A reconciliation between the opening and the closing value of each class of contributed equity. (i.e. share capital by class, share premium account)

Each of these seven items must be disclosed for ① Equity holders ② Minority interests and ③ In total (these are marked ①, ② and ③ in Example 6.1).

These seven items listed above are cross-referenced in the two examples to follow using the symbols ❶ to ❷. The example is adapted from IAS 1 (items not relevant to the MBA course are deleted from the IAS 1 example).

Example 6.1 is quite long because it starts with the opening balance of the comparative (i.e. previous) year (i.e. Balances at 31 December 20X0). The seven items listed above are then disclosed for 20X1 (the comparative or previous year). The example is then continued on the next page with the opening balance of the current year (i.e. Balances at 31 December 20X1). The seven items listed above are then disclosed for 20X2 (the current year).

IAS 1 permits two possible approaches to presenting changes in equity.

1. The columnar single stage approach (this is the approach followed in Example 6.1)
2. The second approach presents the information in two stages:
 - (a) Statement of recognised income and expense is shown as part of the financial statements (after the income statement) – items 1-4 above are shown here; and
 - (b) a columnar reconciliation of opening and closing balances of share capital, other reserves, translation reserves and retained earnings, is given in the notes – items 5-7 above are shown here (this is the approach taken by CRH plc).

The columnar approach is the approach taken in Example 6.1.

6. Statement of changes in equity

Example 6.1: Statement of changes in equity for the year ended 31 December 20X2 (adapted from the example in IAS 1)
(in thousands of currency units)

	① Attributable to equity holders of the parent				Total	② Minority interest	③ Total equity
	Share capital	Other reserves ¹	Translation reserve	Retained earnings ⁶			
Balance at 31 December 20X0⁷	X	X	(X)	X ⁶	X	X	X
Changes in accounting policy ⁴				(X) ⁶	(X)	(X)	(X)
Restated balance	X	X	(X)	X ⁶	X	X	X
Changes in equity for 20X1							
Gain on property revaluation ²		X			X	X	X
Exchange differences on translating foreign operations ²			(X)		(X)	(X)	(X)
<i>Net income recognised directly in equity</i>		X	(X)		X	X	X
Profit for the period ¹				X ⁶	X	X	X
Total recognised income and expense for the period³		X	(X)	X ⁶	X	X	X
Dividends ⁵				(X) ⁶	(X)	(X)	(X)
Issue of share capital ⁵	X				X		X
Balance at 31 December 20X1 carried forward⁷	X	X	(X)	X ⁶	X	X	X
Balance at 31 December 20X1 brought forward⁷							
X	X	(X)	X ⁶	X	X	X	X
Changes in equity for 20X2							
Loss on property revaluation ²		(X)			(X)	(X)	(X)
Exchange differences on translating foreign operations ²			(X)		(X)	(X)	(X)
<i>Net income recognised directly in equity</i>		(X)	(X)		(X)	(X)	(X)
Profit for the period ¹				X ⁶	X	X	X
Total recognised income and expense for the period³		(X)	(X)	X ⁶	X	X	X
Dividends ⁵				(X) ⁶	(X)	(X)	(X)
Issue of share capital ⁵	X				X		X
Balance at 31 December 20X2⁷	X	X	(X)	X ⁶	X	X	X

¹ Other reserves are analysed into their components, if material

Items ① to ⑦ are the items to be shown on the statement of changes in equity per IAS 1 and as described on the previous page of these notes.

6. Statement of changes in equity

An alternative method of presenting changes in equity is illustrated in Example 6.2 below. Changes in equity representing income and expense are presented in a separate component of the financial statements (*Statement of recognised income and expense*). A reconciliation of opening and closing balances of share capital, other reserves, translation reserves and retained earnings, as illustrated in Example 6.1, is given in the notes.

Example 6.2: Statement of recognised income and expense for the year ended 31 December 20X2

	20X2 €000	20X1 €000
Gain/(loss) on revaluation of properties ²	(X)	X
Exchange differences on translation of foreign operations ²	(X)	(X)
<i>Net (losses)/gains recognised directly in equity</i>	(X)	X
Profit for the period ¹	X	X
Total recognised income and expense for the period³	X	X
Attributable to:		
- Equity holders of the parent	X	X
- Minority interest	X	X
	<u>X</u>	<u>X</u>
Effect of changes in accounting policy: ⁴		
- Equity holders of the parent		(X)
- Minority interest		(X)
		<u>(X)</u>

CRH 2010 Q29: What is included in CRH's statement of changes in equity in its 2010 financial statements?

6. Statement of changes in equity

Consolidated Statement of Changes in Equity

for the financial year ended 31 December 2010

Notes	Attributable to the equity holders of the Company							
	Issued share capital €m	Share premium account €m	Treasury Shares/ own shares €m	Other reserves €m	Foreign currency translation reserve €m	Retained income €m	Non- controlling interests €m	Total equity €m
At 1 January 2010	242	3,778	(279)	128	(740)	6,508	73	9,710
Group profit for the financial year	-	-	-	-	-	432	7	439
Other comprehensive income	-	-	-	-	514	(19)	5	500
Total comprehensive income	-	-	-	-	514	413	12	939
29 Issue of share capital (net of expenses)	3	137	-	-	-	-	-	140
8 Share-based payment expense	-	-	-	-	-	-	-	-
- share option schemes	-	-	-	9	-	-	-	9
- Performance Share Plan (PSP)	-	-	-	10	-	-	-	10
11 Tax relating to share-based payment expense	-	-	-	-	-	(2)	-	(2)
Treasury/own shares reissued	-	-	80	-	-	(80)	-	-
Share option exercises	-	-	-	-	-	45	-	45
12 Dividends (including shares issued in lieu of dividends)	-	-	-	-	-	(438)	(6)	(444)
31 Non-controlling interests arising on acquisition of subsidiaries	-	-	-	-	-	-	6	6
Acquisition of non-controlling interests	-	-	-	-	-	-	(2)	(2)
At 31 December 2010	245	3,915	(199)	147	(226)	6,446	83	10,411

for the financial year ended 31 December 2009

At 1 January 2009	187	2,448	(378)	87	(644)	6,387	70	8,157
Group profit for the financial year	-	-	-	-	-	592	6	598
Other comprehensive income	-	-	-	-	(96)	(34)	-	(130)
Total comprehensive income	-	-	-	-	(96)	558	6	468
29 Issue of share capital (net of expenses)	55	1,330	-	-	-	-	-	1,385
8 Share-based payment expense	-	-	-	-	-	-	-	-
- share option schemes	-	-	-	18	-	-	-	18
- Performance Share Plan (PSP)	-	-	-	10	-	-	-	10
Reclassification of Performance Share Plan expense	-	-	(13)	13	-	-	-	-
11 Tax relating to share-based payment expense	-	-	-	-	-	3	-	3
Treasury/own shares reissued	-	-	114	-	-	(114)	-	-
29 Shares acquired by Employee Benefit Trust (own shares)	-	-	(2)	-	-	-	-	(2)
Share option exercises	-	-	-	-	-	60	-	60
12 Dividends (including shares issued in lieu of dividends)	-	-	-	-	-	(386)	(7)	(393)
31 Non-controlling interests arising on acquisition of subsidiaries	-	-	-	-	-	-	4	4
At 31 December 2009	242	3,778	(279)	128	(740)	6,508	73	9,710

K. McGowan, M. Lee, Directors

6. Statement of changes in equity

6.3 Examples

Example 6.3 shown below adopts the single statement columnar approach. It is possible to split the statement, showing lines 1-4 of the requirement as a Statement of recognised income and expense and place the remainder in a note.

Example 6.3: Statement of Changes in Equity

ALF plc Statement of Changes in Equity for the year ended 31st December 20X5

	Attributable to equity holders of the parent				Minority Interest	Total Equity
	Ordinary Share Capital	Revaluation Reserve	Retained earnings	Total		
	€m	€m	€m	€m		
20X5						
Gain on property revaluation		12		12	2	14
Exchange differences on translation of foreign operations			(25)	(25)	(4)	(29)
Tax on items taken direct to this statement		(20)	-	(20)	(3)	(23)
<i>Net (loss) recognised directly in equity</i>	-	(8)	(25)	(33)	(5)	(38)
Profit for the period			28	28	8	36
<i>Total recognised income and expense for the period</i>	-	(8)	3	(5)	3	(2)
Dividends paid			(20)	(20)		(20)
Issue of shares at par	20			20		20
	20	(8)	(17)	(5)	3	(2)
Balances at 1st January 20X5	50	10	80	140	20	160
Balances at 31st December 20X5	70	2	63	135	23	158
20X4	Attributable to equity holders of the parent				Minority Interest	Total Equity
	Ordinary Share Capital	Revaluation Reserve	Accumulated Profit	Total		
	€m	€m	€m	€m	€m	€m
Exchange differences on translation of foreign operations			15	15	1	16
<i>Net gains recognised directly in equity</i>	-	-	15	15	1	16
(Loss) for the period			(9)	(9)	(2)	(11)
<i>Total recognised income and expense for the period</i>	-	-	6	6	(1)	5
Dividends paid			(20)	(20)		(20)
Issue of shares at par	5			5		5
	5	-	(14)	(9)	(1)	(10)
Balances at 1st January 20X4	45	10	94	149	21	170
Balances at 31st December 20X4	50	10	80	140	20	160

In relation to Example 6.3 above:

1. How much are opening equity/shareholders' funds for 20X4 and 20X5?
2. How many transactions/items are dealt with directly in equity? What are they?
3. What was the profit for the period?
4. What was the retained profit for the period?
5. How many transactions were there with shareholders?
6. How much is closing equity/shareholders' funds?

Example 6.4 shown below also adopts the single statement columnar approach.

6. Statement of changes in equity

Example 6.4: Statement of changes in equity – reconciliation of opening and closing balances

	Attributable to equity holders of the parent					Total €000
	Share Capital €000	Share premium €000	Revaluation surplus €000	Foreign exchange differences €000	Accumulate d profit €000	
	Balance at 1 January 20X8	30,000	10,424	5,210	1,300	
- as previously reported	30,000	10,424	5,210	1,300	56,978	103,912
- effect of adopting revised IAS 12	-	-	-	-	4,413	4,413
- as restated	30,000	10,424	5,210	1,300	61,391	108,325
Revaluation of property			2,600			2,600
Foreign exchange differences				2,875		2,875
<i>Net gains recognised directly in equity</i>			2,600	2,875		5,475
Net profit for the period					22,414	22,414
<i>Total recognised income and expense for the period</i>			2,600	2,875	22,414	27,889
Dividends paid					(15,736)	(15,736)
Issue of share capital	15,000	5,000				20,000
Balance at 31 December 20X8	45,000	15,424	7,810	4,175	68,069	140,478

Example 6.5 is a simple example, illustrating the mechanics of preparing a statement of changes in equity based on some basic data.

Example 6.5: Preparation of a statement of changes in equity

At 1 January 20X5 a company had three components of shareholders' equity:
 Share capital of €4 million
 Retained earnings of €6 million.

During the year profits were €2 million, dividends of €3 million were paid, and plant was revalued from €4 million to €5 million.

Question

Prepare the statement of changes in equity, based on the above information.

Solution

	Share capital €m	Revaluation reserve €m	Retained earnings €m	Total €m
Opening balance at 1/1/20X5	4	nil	6	10
<i>Changes in equity for 20X5</i>				
Gain on property revaluation		1		1
<i>Net income recognised directly in equity</i>		1		1
Profit for the period			2	2
<i>Total recognised income and expense for the period</i>		1	2	3
Dividends paid			(3)	(3)
Closing balance at 31/12/20X5	4	1	5	10

7. Reporting Financial Performance

Section 7: Reporting financial performance

- 7.1 Accounting abuses in the past
 - 7.1.1 Reserve accounting
 - 7.1.2 Exceptional and extraordinary items
 - 7.1.3 Earnings management/Income smoothing
 - 7.1.4 Big bath accounting
 - 7.1.5 Anticipating income
 - 7.1.6 Deferring costs
 - 7.1.7 Pro forma earnings
- 7.2 Exceptional and extraordinary items
 - 7.2.1 FRS 3 *Reporting Financial Performance*
 - 7.2.2 IAS 1 *Presentation of Financial Statements*
- 7.3 Continuing and discontinued operations
 - 7.3.1 Classification of operation as discontinued
 - 7.3.2 Presentation of discontinued operations
 - 7.3.3 Comparative amounts
- 7.4 Examples of treatment of discontinued operations in the income statement

7.1 Accounting abuses in the past

In the past, accounting abuses which have required regulators to take step in relation to income statements. The following abuses were common:

- (1) Reserve accounting
- (2) Extraordinary items
- (3) Earnings management/Income smoothing
- (4) Big bath accounting
- (5) Recognising income too early
- (6) Deferring recognition of expenses/costs
- (7) Pro forma earnings

7.1.1 Reserve accounting

Reserve accounting involves excluding certain profits and losses from the income statement and reporting them as a reserve movement (usually buried deeply in the notes). The argument for this treatment was that unusual and non-recurring transactions should be excluded from the income statement as they would distort the results. As a result of such distortion, investors would find it difficult to make predictions about the future performance and trends of the company. Investors are interested in the financial statement for what they can tell about the future. Assumptions and predictions about the future will assist investors in decision making - for example, whether to buy more shares, hold their shares, or sell their shares)

7.1.2 Exceptional and extraordinary items

Reserve accounting was abolished by Statement of Standard Accounting Practice (SSAP) 6. SSAP 6 introduced two new concepts: Exceptional items and extraordinary items. Exceptional items were defined as gains or losses that were ①material and ②non-recurring. Extraordinary items were defined as gains or losses that were ①material, ②non-recurring and ③outside the normal course of business. Both exceptional and extraordinary items were disclosed separately in the income statement. This allowed investors to exclude these items when predicting trends, etc. Exceptional items and extraordinary items were treated differently in the calculating of earnings per share. Exceptional items were included in earnings per share; extraordinary items were excluded from earnings per share. As a result, many once-off material losses were categorized as extraordinary (and were thus excluded from earnings per share allowing a higher earnings per share to be reported), and may once-off material

7. Reporting Financial Performance

profits were categorized as exceptional (and were thus included in earnings per share also allowing a higher earnings per share to be reported).

7.1.3 Earnings management/Income smoothing

Motives

Earnings may be managed to:

- Increase the share price before issuing more shares
- Increase the share price before managers exercise stock options
- Meet market expectations / analysts' forecasts about earnings
- Avoid reporting decreasing earnings from the prior year
- Avoid reporting a loss
- Project a smooth earnings pattern (income smoothing), portraying a smoother pattern of profits, implying greater stability and less risk, resulting in higher share prices.

Under/overstate income

Profits reported in the income statement can be managed by recognising gains and losses early or late, either bringing them into this year's income statement, or pushing them forward into next year. In a bank, for example, the subject estimated provision for bad debts can be robust (recognizing a lot of cost in the current financial statements) or less prudent (pushing out the cost to future accounting periods). The widespread practice of earnings management has eroded the quality of earnings.

Earnings management vs. income manipulation

It is only a short step between earnings management (the legitimate exercise of judgment) and earnings manipulation or fraudulent financial reporting.

7.1.4 Big bath accounting

Big bath accounting involves making huge provisions, resulting in a big hit to the profit and loss account/income statement. If this happens, for example, on a change in CEO, the departing CEO can be blamed for the hit. The excessive provision can be used as a war chest in the future by the incoming CEO to smooth earnings and to meet analysts' forecasts if the income is insufficient to do so

7.1.5 Anticipating income

The most common form of fraudulent financial reporting is recognizing income too soon. For this reason, IAS 18 *Revenue Recognition* provides guidance on when to recognise income (see section to follow).

7.1.6 Deferring costs

Some companies (notably Worldcom) treat as assets in the balance sheet transactions that should be treated as expenses in the income statement. If assets with no value are capitalized (i.e. recorded in the balance sheet) as assets, they are fictitious assets. The fiction is that they have a future value when in fact they do not.

7.1.7 Pro forma earnings

Companies may prepare pro forma (notional) income statements, and report pro forma earnings. These pro forma earnings are not audited, as they do not appear in the audited income statement. This practice has been referred to as "earnings without the bad stuff".

7. Reporting Financial Performance

7.2 Exceptional and extraordinary items

7.2.1 FRS 3 Reporting Financial Performance

The accounting treatment of exceptional and extraordinary items was tightened up in FRS 3 *Reporting Financial Performance* (UK/Irish Generally Accepted Accounting Principles (GAAP)). Extraordinary items were defined out of existence. Items previously classified as extraordinary items now required to be treated as exceptional items.

FRS 3 also restricts the exceptional items to be shown on the face of the profit and loss account as separate items (restricted to three items) with the rest shown in notes to the financial statement, unless so material as to justify separate disclosure on the face of the profit and loss account.

All realised gains and losses to be shown in the profit and loss account.

7.2.2 IAS 1 Presentation of Financial Statements

International Accounting Standard 1 (IAS 1) *Presentation of Financial Statements* requires full disclosure of changes in equity (reserves) and divides that disclosure between the Income Statement and the Statement of Changes in Equity, both of which are primary statements.

Specific rules are set out what can or must be shown separately on the face of the income statement and there are rules about income recognition.

The basic rule is that all items go into the income statement, unless a specific, stated rule in a standard places the item in the statement of changes in equity. Example of exceptions to the basic rules include Gains/losses foreign currency translation differences; Gains/losses on Revaluations.

In principle, material items of income and expenditure should be shown separately of the face of the income statement to aid the reader's comprehension of separate components of income and expenditure. Exceptional items should be shown as a separate one line item within operating profit, after distribution costs and administration expenses, before finance costs.

The nature and amount of material items of income and expense should be disclosed. These are (in effect) exceptional items although not called as such. Extraordinary items are prohibited in the 2003 revision of IAS 1.

IAS 1 (paragraph 86) suggests that the following specific items (if material) may be shown on the face of the income statement;

- Write-downs of inventories to net realisable value, as well as reversals of such write-downs
- Write-downs of property, plant and equipment to recoverable amount, as well as reversals of such write-downs
- Restructuring of the activities of an entity and reversals of any provisions for the costs of restructuring;
- Profits and losses on the disposals of items of property, plant and equipment
- Profits and losses on the disposals of investments
- Profit or loss on discontinued operations;
- Litigation settlements
- Other reversals of provisions.

IAS 1 provides guidance on what is material.

- Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements.
- Materiality depends on the size and nature of the omissions and misstatement judged in the surrounding circumstances.
- The size or nature of the item, or a combination of both, could be the determining factor.
- Users are assumed to have reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.

7. Reporting Financial Performance

7.3 Continuing and discontinued operations

It is important for investors to be informed of discontinued operations. For this reason, separate disclosure is required of discontinued operations in the income statement and in the notes to the accounts. The income statement must clearly distinguish between continuing operations and discontinued operations.

Large companies usually consist of a number of subsidiary operations or divisions. Companies often buy, sell or close these down, as the needs of their strategy dictate. Discontinued operations are operations which an entity has disposed of or contracted to dispose of, *at the balance sheet date*. It is desirable to separate these from continuing activities in the income statement as the continuing activities show the future profit potential of the entity, while the discontinued activities are no longer relevant. IFRS 5 *Non-current assets held for sale and discontinued operations* requires that a separate, net figure is shown for the results of discontinued operations. An individual income statement should be shown separately for the discontinued operations, either on the face of the income statement or in the notes.

7.3.1 Classification of operation as discontinued

Activities are treated as discontinued, only if arrangements for discontinuance (e.g. disposal) have begun before the year end. This is not something that can occur after the year end.

7.3.2 Presentation of discontinued operations

In circumstances where there are discontinued operations, under IFRS 5 *Non-current assets held for sale and discontinued operations* the following must be shown in the income statement:

Continuing operations

- Revenue
- Cost of sales
- Gross profit
- Other income
- Distribution costs
- Administrative expenses
- Finance costs
- Share of income/ loss of joint ventures and associates
- Profit before taxation
- Income tax expense
- Profit after tax
- **Post tax profit/ loss of discontinued operations and disposal profits/ losses of the discontinued operation**
- Profit or loss
- Division of profit or loss between the parent company shareholders and minority shareholders.
- Earnings per share data with comparatives (see section further on in these notes dealing with this topic).

A note to the accounts should show in detail the income statement for the discontinued operations and the profit and loss on disposal of the discontinued operations. The total in this note will match the amount disclosed in the income statement for the discontinued operation.

7.3.3 Comparative amounts

Comparative figures are adjusted for the operations being disposed of THIS year. Items are reclassified in the income statement every year in the light of disposals made or being made this year. Thus, the comparative amounts will in total match the amounts disclosed in the previous year's financial statements, their categorization between continuing operations and discontinued operations will change.

7. Reporting Financial Performance

Example 7.1: Categorisation of continuing and discontinued operations

20X5

<i>Parent and Subsidiary</i>	<i>H plc</i>	<i>S Ltd</i>	<i>Income statement 20X5</i>
	€m	€m	€m
Revenue	1,000	100	1,100
Cost of sales	<u>600</u>	<u>60</u>	<u>660</u>
Gross profit	400	40	440
Other income	20	2	22
Distribution costs	(100)	(10)	(110)
Administrative expenses	<u>(150)</u>	<u>(15)</u>	<u>(165)</u>
Profit before taxation	170	17	187
Income tax expense	<u>(30)</u>	<u>(3)</u>	<u>(33)</u>
Profit after taxation	<u>140</u>	<u>14</u>	<u>154</u>

S Ltd was sold in 20X6 at no profit or loss to H plc

Question

You are required to show the comparative amounts that would appear for 20X5 in the 20X6 accounts of H plc

Solution

<i>Continuing operations</i>	20X6	20X5
	€m	€m
Revenue		1,000
Cost of sales		<u>600</u>
Gross profit		400
Other income		20
Distribution costs		(100)
Administrative expenses		<u>(150)</u>
Profit before taxation		170
Income tax expense		<u>(30)</u>
Profit after taxation		140
<i>Results of discontinued operations</i>		<u>14</u>
Profit for period attributable to equity holders		<u>154</u>

Note X Operating result and loss on disposal of discontinued operations

	20X6	20X5
<i>Operating result</i>	€m	€m
Revenue		100
Cost of sales		<u>60</u>
Gross profit		40
Other income		2
Distribution costs		(10)
Administrative expenses		<u>(15)</u>
Profit before taxation		17
Income tax expense		<u>(3)</u>
Profit after taxation		<u>14</u>

7. Reporting Financial Performance

7.4 Examples of treatment of discontinued operations in the income statement

In Example 7.2, the discontinued operation is shown as a single line item in the income statement, with full details of the discontinued operation in a note to the accounts.

Example 7.2 ALF plc Income statement for the year ended 31 December 20X5		
	20X5	20X4
	€m	€m
<i>Continuing operations</i>		
Revenue	650	550
Cost of sales	<u>(460)</u>	<u>(445)</u>
Gross profit	190	105
Distribution costs	(50)	(40)
Administrative expenses	(54)	(43)
<i>Profit on sale of properties in continuing operations</i>	9	6
Finance costs	<u>(18)</u>	<u>(15)</u>
Profit before taxation	77	13
Income tax expense	<u>(14)</u>	<u>(4)</u>
Profit after taxation	63	9
① <i>Operating result and</i> ② <i>loss on disposal of discontinued operations (Note 27)</i>	<u>(17)</u>	<u>(20)</u>
Profit	<u>46</u>	<u>(11)</u>
Attributable to:		
Equity holders' of the parent	38	(9)
Minority interest	<u>8</u>	<u>(2)</u>
	<u>46</u>	<u>(11)</u>
Note 27 Operating result and loss on disposal of discontinued operations		
	20X5	20X4
	€m	€m
<i>Operating result</i>		
Revenue	150	142
Cost of sales	<u>(140)</u>	<u>(130)</u>
Gross profit	10	12
Distribution costs	(31)	(20)
Administrative expenses	(21)	(20)
Finance revenues	<u>2</u>	<u>3</u>
Loss before taxation	(39)	(25)
Income tax saving	<u>12</u>	<u>5</u>
① Loss after taxation	(27)	(20)
② Profit on disposal of discontinued operations	<u>10</u>	<u>-</u>
	<u>(17)</u>	<u>(20)</u>

8. Cash flow statements

Section 8: Cash Flow Statements
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8.1.1 Example
8.1.2 Summary
8.2 International Accounting Standard (IAS) 7 <i>Cash Flow Statements</i>
8.2.1 Scope
8.2.2 Standard accounting practice
8.2.3 Notes to the cash flow statement
8.2.4 Example of the indirect method from IAS 7 (adapted)
8.2.5 Example cash flow statement applying IAS 7
8.2.6 Example cash flow statement including stock
8.3 Preparation of cash flow statements
8.3.1 Cash flows from operations
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8.3.4 Pitfalls to avoid
8.3.4.1 Profit before taxation
8.3.4.2 Increase in capital reserve
8.3.4.3 Movements in fixed asset accounts
8.3.4.4 Proceeds on issue of shares
8.3.4.5 Dividends paid
8.3.4.6 Tax paid

8.1 Background

The income statement shows the amount of profit made during an accounting period but does not explain why the amount of cash available to the organisation has increased or decreased during the accounting period. The balance sheet shows the company's resources at the beginning/end of the accounting period. For a fuller understanding of the company's affairs it is necessary to identify the movement in assets, liabilities and capital that have taken place during the accounting period giving rise to the change in the cash balances during the period.

This information is not specifically disclosed in the income statement or balance sheet. It can be made available in the form of a statement of cash flow. The cash flow statement explains the opening and closing cash i.e. change in the cash at bank and in hand less short term borrowings.

A cash flow statement can be used to answer questions such as:-

- Where did all the profits go?
- If those are our profits, why wasn't it possible to pay a larger dividend?
- What happened to the cash generated from our recent share issue (or disposal of assets)?

The income statement is based on the accruals concept i.e. Revenues are recorded when they are earned (*not when they are received*) and expenses are recorded when they are incurred (*not when they are paid*).

This means that the income statement **does not** reflect changes in the **cash** position of the business.

8. Cash flow statements

8.1.1 Example

Example 8.1: Profit does not reflect changes in cash position

ABC Ltd. commenced business with €5,000 in capital. It made credit sales of €100,000 in the first year and incurred expenses of €80,000. At the end of the year only €40,000 had been received from accounts receivable / debtors and €60,000 had been paid to accounts payable/creditors.

Question

- (1) Calculate the profit for the year
- (2) Calculate the cash inflow for the year
- (3) Explain the difference in the amount of profit and the cash inflow for the year

Solution

<i>(1) Profit for year</i>		€
Sales	100,000	
Less: Expenses	<u>(80,000)</u>	
Profit	<u>20,000</u>	

<i>(2) Cash inflow for year</i>	
Balance at start of year	5,000
Received from Accounts receivable/debtors	40,000
Paid to Accounts payable/creditors	<u>(60,000)</u>
Balance at end of year	<u>(15,000)</u>

=> Even though the company made a profit of €20,000 the balance at the bank was €20,000 smaller than at the start of the year

(3) Explain the difference

	Income statement	Cash flow	Difference
	€	€	€
Sales	100,000	40,000	(60,000)
Purchases	<u>(80,000)</u>	<u>(60,000)</u>	<u>20,000</u>
Profit	<u>20,000</u>	<u>(20,000)</u>	<u>(40,000)</u>

- Even though the company made a profit of €20,000 the balance at the bank was €20,000 smaller than at the start of the year – a difference of €40,000. This difference is accounted for by:
- €20,000 less cash was paid to creditors than are included as purchases in the profit and loss account / income statement
- €60,000 less cash was received from debtors than was recorded as sales in the profit and loss account

8.1.2 Summary

- Cash is king
- Income statement shows the amount of profit made in an accounting period
- Balance sheet shows the residual amounts of assets, liabilities and capital at the end of the accounting period
- Neither directly shows why the firm's cash balances increased/decreased during the period

The cash flow statement aims to show why the cash balance changed during the year i.e. to explain / reconcile: Opening cash balance + Inflows – Outflows = Closing Cash Balance

8. Cash flow statements

The inflows may be:

- Cash sales
- Cash from trade receivables
- Disposal of property, plant equipment
- Other income e.g. investment income
- Loans received
- New share capital issued

Outflows could be:

- Payments to suppliers and cash purchases
- Payments to trade payables for credit purchases
- Expenses paid
- Purchase of assets
- Taxation
- Interest payments
- Loan repayments

To summarise:

The objective of the cash flow statement is to identify the movement in assets, liabilities and capital during the year, giving rise to the change in opening and closing cash.

The preparation of a cash flow statement involves the re-arrangement of the information in the balance sheet and income statement to identify the movements in assets, liabilities and capital.

8.2 International Accounting Standard (IAS) 7 Cash Flow Statements

IAS 7 recommends the reporting of cash flows and provides a standard format to be followed. The objective of the IAS is to require businesses to report on a standard basis their cash generation and absorption for a period.

8.2.1 Scope

- All entities are required to prepare cash flow statements

8.2.2 Standard accounting practice

(Items crossed out / in square brackets in this and the next two sections, although part of IAS 7, will not be examined in the MBA course)

- IAS 7 lays down a format for cash flow statements and specifies certain disclosures to be made in the notes to the statement
- Comparative amounts are required
- Two methods of preparing the statement are allowed;
 - ◆ Direct method (showing relevant constituent cash flows) ➡ Less common and not covered in this course
 - ◆ Indirect method (Adjustment-to-profit approach) ➡ Method followed in this course
- Certain terms are defined in the standard

Cash flow statements should:

- (1) List cash inflows and outflows under the following three headings (and in that order)
- (2) Showing the total for each heading,

Headings

- Cash flows from operating activities (e.g. inflows from profitable trading)
- Cash flows from investing activities
- Cash flows from financing activities (e.g. (i) Issue and repayment of loans and (ii) Share capital movements)

These make up the net movement in cash for the period.

8. Cash flow statements

8.2.3 Notes to the cash flow statement

- ~~[Acquisition of subsidiary]~~
- ~~[Property plant and equipment]~~
- ~~[Cash and cash equivalents]~~
- ~~[Segment information]~~

8.2.4 Example of the indirect method from IAS 7 (adapted)

Example 8.2: Cash flow statement for the year ended 31 December 20X6

	€000	€000
Cash flows from operating activities		
Operating profit before taxation	3,350	
Adjustments for:		
Depreciation charges <small>Note 1</small>	450	
[Foreign exchange loss]	40]	
Investment income <small>Note 2</small>	① (500)	
Interest expense <small>Note 3</small>	② 400	
	3,740	
Increase in trade and other receivables <small>Note 4</small>	(500)	
Decrease in inventories <small>Note 5</small>	1,050	
Decrease in trade payables <small>Note 6</small>	(1,740)	
Cash generated from operations	2,550	
Interest paid <small>Note 3</small>	② (270)	
Income taxes paid	(900)	
Net cash from operating activities		1,380
Cash flows from investing activities		
[Acquisition of subsidiary X net of cash acquired]	(550)]	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
Interest received <small>Note 2</small>	① 200	
Dividends received <small>Note 2</small>	① 200	
Net cash used in investing activities		(480)
Cash flows from financing activities		
Proceeds from issue of share capital	250	
Proceeds from long term borrowings	250	
[Payment of finance lease liabilities]	(90)]	
Dividends paid <small>Note 7</small>	(1,200)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		110
Cash and cash equivalents at beginning of period		120
Cash and cash equivalents at end of period		<u>230</u>

Explanatory notes to Example 8.2

- Note 1:* Depreciation is an accounting adjustment and does not involve the outflow of cash (that takes place when the asset (being depreciated) is purchased initially. Depreciation was deducted in arriving at profit before taxation. It is adjusted by adding it back in the cash flow statement. This cancels / nullifies the deduction of depreciation in arriving at profit before tax.
- Note 2:* Investment income is added in arriving at profit before tax. It is adjusted by deducting it in the cash flow statement. This cancels / nullifies the inclusion of investment income in arriving at profit before tax. The reason for this is two-fold: (i) The cash flow statement should include investment income received in cash, not investment income earned (accruals amount); (ii) Investment income received in cash should be dealt with in the cash flow from investment activities section of the cash flow statement, not the cash flow from operating activities section. While 500 investment income earned is taken out in the adjustments, interest received €200,000 and dividends received €200,000 are included in cash flow from investment

8. Cash flow statements

activities. This implies that investment income of €100,000 ($500_{\text{Investment income}} - 200_{\text{Interest received}} - 200_{\text{Dividends received}}$) was accrued.

Note 3: Interest expense is deducted in arriving at profit before tax. It is adjusted by adding it back in the cash flow statement. This cancels / nullifies the deduction of interest expense in arriving at profit before tax. The reason for this is that the cash flow statement should only include interest paid in cash, not interest expense (accruals amount).

Note 4: If accounts receivable/debtors increase, this means we did not get the sales to debtors in cash. Accordingly we have to reduce the cash received by the increase in debtors. And vice versa.

Note 5: If inventories increase it means we have not got that amount in cash – the cash is tied up in inventory. Accordingly, we have to reduce the cash by the amount tied up in stock. And vice versa.

Note 6: If accounts payable/creditors increase, this means we have retained cash by not paying our obligations too soon. Accordingly, we have more cash by the increase in creditors. And vice versa

Note 7: Dividends paid may be shown as either relating to financing activities or as operating activities.

Working capital (Current assets-current liabilities) management is critical to a company's cash position. Movements in working capital are revealed by the cash flow statement, which provides useful additional insights to the company's management of its cash and net assets position.

8. Cash flow statements

CRH 2010 Q30: Compare the above illustrative cash flow statement and CRH's cash flow statement in its 2010 financial statements?

Consolidated Statement of Cash Flows

for the financial year ended 31 December 2010

	2010 €m	2009 €m
Notes		
	Cash flows from operating activities	
	534	732
9	247	297
10	(28)	(48)
5	(55)	(26)
	698	955
3	786	794
3	131	54
8	19	28
	(35)	(37)
20	142	740
	1,741	2,534
	(283)	(294)
25	33	65
	(100)	(104)
	1,391	2,201
	Cash flows from investing activities	
5	188	103
	35	31
	51	38
14	(466)	(532)
31	(436)	(174)
16	(49)	(235)
16	(18)	(9)
20	(27)	(37)
20	115	(115)
	(607)	(930)
	Cash flows from financing activities	
29	-	1,237
	45	60
	(2)	-
	566	757
	82	16
	-	(2)
	(865)	(2,501)
12	(298)	(238)
12	(6)	(7)
	(496)	(678)
	286	593
	Reconciliation of opening to closing cash and cash equivalents	
25	1,372	799
	72	(20)
	286	593
25	1,730	1,372
	Reconciliation of opening to closing net debt	
25	(3,723)	(6,091)
	(33)	(65)
31	(37)	(3)
	(566)	(757)
	(82)	(16)
	665	2,501
	286	593
	18	(5)
	(221)	120
25	(3,473)	(3,723)

K. McGowan, M. Lee, Directors

8. Cash flow statements

8.2.5 Example cash flow statement applying IAS 7

Example 8.3 is based on Example 8.1. However, the data is applied to preparing a cash flow statement in the format required by IAS 7.

Example 8.3: Applying cash flow format to Example 8.1

ABC Ltd. commenced business with €5,000 in capital. It made credit sales of €100,000 in the first year and incurred expenses of €80,000. At the end of the year only €40,000 had been received from accounts receivable/debtors and €60,000 had been paid to accounts payable/creditors.

Question

(1) Show the cash flow statement reflecting the above transactions

Solution

	€	
Cash flows from operating activities		
Profit before taxation (100,000 _{Sales} - 80,000 _{Expenses})	20,000	
Adjustments for:		
Increase in trade receivables (nil _{Opening balance} - 60,000 _{Closing balance})	(60,000)	
Increase in trade payables (nil _{Opening balance} - 20,000 _{Closing balance})	<u>20,000</u>	
<i>Net cash from operating activities</i>		(20,000)
Cash flows from financing activities		
Proceeds from increase of capital	<u>5,000</u>	
<i>Net cash from financing activities</i>		<u>5,000</u>
Net decrease in cash and cash equivalents		(15,000)
Cash and cash equivalents at beginning of period		<u>Nil</u>
Cash and cash equivalents at end of period		<u>(15,000)</u>

8. Cash flow statements

8.2.6 Example cash flow statement including stock

Example 8.4 is based on Example 8.1. However, an additional piece of information is that there is closing stock.

Example 8.4: Including stock in Example 8.1																																									
<p>ABC Ltd. commenced business with €5,000 in capital. It made credit sales of €100,000 in the first year and incurred expenses of €80,000. At the end of the year only €40,000 had been received from the accounts receivable/debtors and €60,000 had been paid to accounts payable/creditors. Closing stock amounted to €7,000.</p>																																									
Question																																									
<p>(1) Show the income statement reflecting the above transactions (2) Show the cash flow statement reflecting the above transactions</p>																																									
Solution																																									
<p>(1) <i>Income statement showing profit for year</i></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;"></td> <td style="width: 10%; text-align: right;">€</td> <td style="width: 10%;"></td> </tr> <tr> <td>Sales</td> <td></td> <td style="text-align: right;">100,000</td> </tr> <tr> <td>Less: Cost of sales</td> <td></td> <td></td> </tr> <tr> <td>Expenses</td> <td style="text-align: right;">80,000</td> <td></td> </tr> <tr> <td>Closing stock</td> <td style="text-align: right;"><u>(7,000)</u></td> <td style="text-align: right;"><u>(73,000)</u></td> </tr> <tr> <td>Profit</td> <td></td> <td style="text-align: right;"><u>27,000</u></td> </tr> </table>				€		Sales		100,000	Less: Cost of sales			Expenses	80,000		Closing stock	<u>(7,000)</u>	<u>(73,000)</u>	Profit		<u>27,000</u>																					
	€																																								
Sales		100,000																																							
Less: Cost of sales																																									
Expenses	80,000																																								
Closing stock	<u>(7,000)</u>	<u>(73,000)</u>																																							
Profit		<u>27,000</u>																																							
<p>(2) <i>Reconciliation of operating profit to net cash outflow for period</i></p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;"></td> <td style="width: 10%; text-align: right;">€</td> <td style="width: 10%; text-align: right;">€</td> </tr> <tr> <td colspan="3">Cash flows from operating activities</td> </tr> <tr> <td>Profit before taxation</td> <td style="text-align: right;">27,000</td> <td></td> </tr> <tr> <td>Increase in inventories (nil_{Opening balance} – 7,000_{Closing balance})</td> <td style="text-align: right;">(7,000)</td> <td></td> </tr> <tr> <td>Increase in trade receivables (nil_{Opening balance} – 60,000_{Closing balance})</td> <td style="text-align: right;">(60,000)</td> <td></td> </tr> <tr> <td>Increase in trade payables (nil_{Opening balance} – 20,000_{Closing balance})</td> <td style="text-align: right;"><u>20,000</u></td> <td></td> </tr> <tr> <td>Cash from operating activities</td> <td></td> <td style="text-align: right;"><u>(20,000)</u></td> </tr> <tr> <td colspan="3">Cash flows from financing activities</td> </tr> <tr> <td>Increase in capital</td> <td style="text-align: right;"><u>5,000</u></td> <td></td> </tr> <tr> <td><i>Net cash raised from financing activities</i></td> <td></td> <td style="text-align: right;"><u>5,000</u></td> </tr> <tr> <td>Net decrease in cash and cash equivalents</td> <td></td> <td style="text-align: right;"><u>(15,000)</u></td> </tr> <tr> <td>Cash and cash equivalents at beginning of period</td> <td></td> <td style="text-align: right;"><u>Nil</u></td> </tr> <tr> <td>Cash and cash equivalents at end of period</td> <td></td> <td style="text-align: right;"><u>(15,000)</u></td> </tr> </table>				€	€	Cash flows from operating activities			Profit before taxation	27,000		Increase in inventories (nil _{Opening balance} – 7,000 _{Closing balance})	(7,000)		Increase in trade receivables (nil _{Opening balance} – 60,000 _{Closing balance})	(60,000)		Increase in trade payables (nil _{Opening balance} – 20,000 _{Closing balance})	<u>20,000</u>		Cash from operating activities		<u>(20,000)</u>	Cash flows from financing activities			Increase in capital	<u>5,000</u>		<i>Net cash raised from financing activities</i>		<u>5,000</u>	Net decrease in cash and cash equivalents		<u>(15,000)</u>	Cash and cash equivalents at beginning of period		<u>Nil</u>	Cash and cash equivalents at end of period		<u>(15,000)</u>
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8.3 Preparation of cash flow statements

8.3.1 Cash flow from operations

The most common recurring source of cash is profitable trading. This is referred to as cash from operating activities. If all transactions were conducted on a cash basis then net profit earned would correspond to the increase in the cash resources of the firm.

However, the net profit figure under accruals accounting contains certain non-cash items of expenditure of which depreciation is the most common. Depreciation is simply a bookkeeping entry which has no effect on cash. The related transaction, purchase of property plant and equipment, has an effect on cash but depreciation has no effect. Thus, the profit before tax for the year should be adjusted for depreciation and other non-cash transactions such as profit/loss on disposal of a fixed asset, amortisation of goodwill, write off of preliminary expenses, etc. These need to be adjusted for against profit before taxation to calculate “Cash generated from operations”.

8. Cash flow statements

Disposals of assets are dealt with elsewhere (generally as part of Cash flows from investing activities) in the cash flow statement so profits/losses on disposals, which are included in the operating profit figure, need to be excluded for the purposes of calculating cash flows from operating activities.

Investment income and interest expense are adjusted out of the cash flows from operating activities:

- (1) These are dealt with elsewhere in the cash flow statement (Cash flows from investing activities and after Cash generated from operations).
- (2) The amounts included in the cash flow statement are the amounts paid or received, not the income or expense

Some of the cash generated by trading may be used to finance debtors, invest in stocks or to pay off creditors. These are all part of normal operating activities. Cash flows from operating activities are net of these changes.

Cash from operations can be determined by taking the profit before tax figure (usually given or can be derived)) and adding back the depreciation expense, and other adjustments.

An additional adjustment is required to show the amount of cash reserves used up in maintaining stock levels, debtors and in paying off creditors. Thus if stocks increase, debtors increase or creditors decrease, cash will be used up to finance these increases. This must be adjusted for out of cash generated by operations. A decrease in stock/debtors or an increase in creditors will release cash and will increase the cash flows from operations.

Thus we get:

- Profit before tax
- Add: Depreciation
- Less: Profit on disposal of property plant and equipment (not illustrated in example in IAS 7)
- Add: Loss on disposal of property plant and equipment (not illustrated in example in IAS 7)
- Less: Investment income
- Add: Interest expense
- (Less) Add: (Increase) Decrease in Inventories
- (Less) Add: (Increase) Decrease in Trade receivables
- (Less) Add: (Decrease) Increase in Trade payables
- = Cash generated from operations
- Interest paid
- Income taxes paid
- = Net cash from operating activities

8.3.2 Cash flow from investing activities

Included here are receipts and payments arising from:

- ~~[Acquisitions and disposals (of subsidiaries, associates and joint ventures)]~~
- Capital expenditure, including payments to acquire intangible non-current assets, payments to acquire tangible non-current assets
- Receipts from disposal of tangible non-current assets
- Interest received (not interest income)
- Dividends received (not dividend income)

8.3.3 Cash flow from financing activities

Included here are receipts from, and repayment of, principal sum borrowed (not interest which is dealt with elsewhere in the cash flow statement) to external providers of finance. Examples of financing cash flows are:-

- Proceeds from issuing shares
- Proceeds from issuing debentures, loans, etc.
- Redemption of shares
- ~~[Capital element of finance lease rental payments]~~

8. Cash flow statements

- Repayment of amounts borrowed
- ~~[Expenses of or commission paid on the issue of shares, debentures, loans etc.]~~

Dividends paid can be dealt with here, as a cash outflow from financing activities or in cash flows from operations.

8.3.4 Pitfalls to avoid

8.3.4.1 Profit before taxation

Questions usually include an Income Statement, Statement of Changes in Equity and a Balance sheet. However, occasionally the Income Statement will not be included. As a result profit before taxation may not be given in the question. Instead, it may need to be calculated or derived from balance sheet and other information as follows:-

Difference in opening and closing profit/ loss account balance
Add back: Appropriations: Transfer general reserve
 Appropriations: Dividends charged in income statement
 Tax charged in income statement (\neq tax paid)

8.3.4.2 Increase in capital reserve

If this arises from the revaluation of property plant and equipment ignore. There is no cash effect.

8.3.4.3 Movements in fixed asset accounts

Four amounts relating to property plant and equipment are required in cash flow statements.

1. Depreciation (Cash flows from operating activities)
2. Profit/loss on disposal of property plant and equipment (Cash flows from operating activities)
3. Payments for additions to property plant and equipment (Cash flows from investing activities)
4. Proceeds on disposal of property plant and equipment (Cash flows from investing activities)

Questions often do not provide these amounts.

These can be calculated / derived by reconciling movements in property plant and equipment as follows:

1. Cost/Valuation

Opening Balance	+ Additions	+ Revaluations	- Disposals	= Closing Balance
@ Cost			@ Cost	@ Cost

2. Aggregate Depreciation

Opening Balance +	Charge for year –	Disposals =	Closing Balance
@ Aggr. depreciation		@ Aggr. depreciation	@ Aggr. depreciation

3. Net Book Value

Opening Balance +	Additions +	Revaluations -	Depreciation	Disposals =	Closing Balance
@ NBV			Charge –	@ NBV	@ NBV

The choice of whether to reconcile (1) the cost, (2) the aggregate depreciation or (3) the net book value depends on the information in the question e.g. if the question only provides data on net book values, only this reconciliation can be used to derive any missing data.

8.3.4.4 Proceeds on issue of shares

Increase in share capital and increase in share premium.

8.3.4.5 Dividends paid

8. Cash flow statements

Under international accounting standards (and unlike UK/Irish accounting standards), dividends paid (amount to appear in cash flow statement) are the same as dividends charged (amount that appears in the statement of changes in equity).

8.3.4.6 Tax paid

Taxation paid (amount to appear in cash flow statement) is not the same as taxation charged (amount to appear in the income statement).

Tax paid usually = Last year's closing liability paid this year
Tax charge = This year's charge in the income statement

Often none of this year's charge is paid in the current year.

The tax paid/charged can be derived from the following:

$\text{Taxation}_{\text{Opening Balance}} + \text{Charged in the income statement} - \text{Paid} = \text{Taxation}_{\text{Closing Balance}}$

Glossary of Accounting Terms

Term	Explanation
Accelerated depreciation	Depreciation that is either at a faster rate than would be suggested by an asset's expected life or using methods that charge proportionately more depreciation in earlier years.
Account	A record of all the booking entries relating to a particular item. For example, the wages account would record all the payments of wages. An account in the double-entry system has a debit side (left) and a credit side (right). 'Accounts' may also mean financial statements, such as balance sheets and profit and loss accounts.
Accounting concepts	The assumptions underlying the preparation of financial statements. The basic assumptions of going concern, accruals, consistency and prudence are included in this glossary.
Accounting period	The period for which accounts are prepared, usually one year.
Accounting policies	Accounting policies are the principles, bases, conventions, rules and practices chosen by businesses to account for their activities i.e. that specify how the effects of transactions and other events are to be reflected in its financial statements. Frequently there is more than one acceptable method of accounting for a particular accounting transaction. Only those accounting policies that are " <i>material</i> " are disclosed.
Accounting principles	In the United States, conventions of practice, but in the United Kingdom something more fundamental and theoretical. Thus, the American Generally Accepted Accounting Principles (GAAP) encompasses a wide range of broad and detailed accounting rules of practice. In the United Kingdom, the detailed rules are often called practices, policies or bases; and broader matters such as accruals or conservatism were traditionally referred to as concepts or conventions. So, in the United Kingdom, GAAP may mean 'generally accepted accounting <i>practices</i> '.
Accounting standards	Technical accounting rules of recognition, measurement and disclosure set by committees of accountants. The exact title of accounting standards varies from country to country. The practical use of the words seems to originate officially with the Accounting Standards Steering Committee (later the Accounting Standards Committee) in the United Kingdom in 1970.

Glossary of Accounting Terms

Term	Explanation
Accounts payable	Alternative expression for creditors i.e., amounts owing by a business to suppliers of goods and services.
Accounts receivable	Alternative expression for debtors i.e., amounts owing to a business by customers who have not yet paid for goods or services received.
Accruals	The accounting concept which requires that revenues and expenses are recognised in the accounting period in which they are earned or incurred rather than in the period in which they are received or paid.
Accumulated depreciation	The total amount by which the accounting value of a fixed asset has so far been reduced to take account of the fact that it is wearing out or becoming obsolete (see depreciation).
Acid test	Name sometimes given to a ratio of some of a business's liquid assets to some of its short-term debts. It is thus one test of the likelihood of liquidity problems. It is also called the quick ratio.
Amortization	Alternative expression for depreciation, particularly that due mainly to the passage of time.
Amortization	A word used, particularly in North America, to refer to depreciation of intangible assets.
Annual report	A report sent annually to the shareholders of a company. It contains the financial statements and explanatory notes, the report of the auditors, the chairman's statement and the directors' report.
Asset	Any property or rights owned or controlled by a company that have expected future economic benefits.
Associated company	A company over which another company or group of companies has a significant influence. An associated company is essentially the same as a related company. A company will normally be assumed to be an associated/related company if between 20% and 50% of its ordinary share capital is owned by another company or group of companies.

Glossary of Accounting Terms

Term	Explanation
Authorised share capital	The maximum amount of a particular type of share in a particular company that may be issued. It may be interesting information to shareholders as it puts a limit on the number of co-owners.
Bad debt	An amount owing from debtors which is not expected to be received.
Balance Sheet	A snapshot of the accounting records of assets, liabilities and equity of a business at a particular moment, most obviously the accounting year end.
Bills of exchange (payable/receivable)	A written order directing that a specified sum of money be paid to a specified person on a specified date.
Brought down (b/d), brought forward (b/f)	To denote the opening balance
Business combinations	Acquisitions or mergers involving two or more companies.
Capital allowances	A system of depreciation used in the determination of taxable income that is unique to the British Isles. This tends to be more generous than the depreciation that accountants charge for financial accounting purposes.
Capital employed	Usually refers to the total of the funds invested by shareholders plus the long-term debt.
Capital lease	US term for finance lease.
Capital expenditure	Expenditure on fixed assets.
Capitalization	The inclusion of an item in a balance sheet.
Carried forward (c/f), carried down (c/d)	To denote the closing balance
Cash flow	The receipts of cash by and payment of cash from a business.

Glossary of Accounting Terms

Term	Explanation
Cash flow statement	A financial statement that reports the cash receipts and cash payments of an accounting period. Financial Reporting Standard No.1 requires all companies to publish a cash flow statement.
Close company	A UK company which is controlled by not more than five shareholders or their families or partners.
Common stock	US term for the ordinary shares in a corporation. Normally a majority of the ownership capital will comprise issues of common stock, though preference/preferred shares are also issued.
Consistency	The accounting concept that a company should use the same accounting policies over time.
Consolidated accounts	A set of financial statements which combine the accounts of a parent company and its subsidiaries as if they were a single entity.
Contingencies	Conditions (usually liabilities) that are known at the date of balance sheet, but of which the future outcome (i.e. the amount of the liability) is not known for certain.
Contingent liabilities	Possible future obligations or present obligations that are remote or unquantifiable. They are not accounted for, in the sense of adjusting the financial statements, but are explained in the notes to the balance sheet.
Corporation tax	The tax that is payable by companies.
Cost of sales/cost of goods sold	The costs of making the products that have been sold in a period (usually consists of raw material, labour and production overhead).
Creditors	Amounts owing by a business to suppliers of goods and services. The US expression is accounts payable.

Glossary of Accounting Terms

Term	Explanation
Current assets	Assets which are already in the form of cash or are expected to be converted into cash within one year from the date of the balance sheet.
Current cost accounting	A system of accounting which adjusts for changing prices.
Current liabilities	Amounts which a company owes which are expected to be paid within one year from the date of the balance sheet. (Also referred to as 'Creditors: amounts falling due within one year'.)
Current rate method	The US term for a method of foreign currency translation. The UK term is closing rate method, although this implies some greater flexibility in the choice of rates.
Current ratio	The current assets divided by the current liabilities of an enterprise at a particular date.
Debentures	Long-term loans which are usually secured on the assets of a company.
Debtors	Amounts owing to a business from customers. The US terminology is accounts receivable.
Deferred asset	An amount owed to a company that is not expected to be received within one year from the date of the balance sheet.
Deferred taxation	An estimate of the tax liability payable at some future date that is due to timing differences in the accounting treatment and the taxation treatment of some types of income and expenditure. For example, the depreciation allowed for tax purposes (capital allowances) may be greater than the depreciation used for accounting purposes in the early years of an asset's life, but the situation will be reversed in later years.
Depreciation	A charge against the profit of an accounting period to represent the estimated proportion of the cost of a fixed asset which has been consumed (whether through use, obsolescence or the passage of time) during that period.

Glossary of Accounting Terms

Term	Explanation
Dividend	The amount distributed to shareholders out of the profits of a company. Large companies will normally pay an interim dividend part way through the financial year, with a final dividend paid after the end of the financial year when it has been approved by the shareholders.
Earnings	A technical accounting term, meaning the amount of profit (normally for a year) available to the ordinary shareholders (UK)/common stockholders (US). That is, it is the profit after all operating expenses, interest charges, taxes and dividends on preferred/preference stock.
Earnings per share (EPS)	The most recent year's total earnings divided by the average number of ordinary/common shares outstanding in the year.
Equity	An element of the balance sheet showing the owners' interests. It is equal to the total assets minus the total liabilities.
Equity method	A method of accounting for investments in associated companies.
Equity share capital	An alternative expression for the normal type of ownership finance, i.e. Ordinary shares. It is defined as any issued share capital which has unlimited rights to participate in either the distribution of dividends or capital.
Exceptional items	Items appearing in the profit and loss account that arise within the ordinary course of business, but are of unusual size.
Extraordinary items	Items of income and expenditure which are significant in amount and which are outside the normal activities of a business.
Exposure drafts	Documents that precede the issue of accounting standards. They are intended to attract response from companies, auditors, academics, investment analysts, financial institutions, etc.

Glossary of Accounting Terms

Term	Explanation
Fair value	The amount that willing buyers and sellers would exchange something for in a market at arm's length. For example, assets and liabilities of new subsidiaries are brought into consolidated accounts at fair values rather than book values. This is designed to be an estimate of their cost to the group at the date of acquisition of a subsidiary.
FIFO (first-in, first out)	A common assumption for accounting purposes about the flow of items of raw materials or other inventories. It need not be expected to correspond with physical reality but may be used for accounting purposes. The assumption is that the first units to be received as part of inventories are the first ones to be used up or sold. This means that the most recent units are deemed to be those left at the period end.
Finance lease	A contract that transfers the majority of risks and rewards of an asset to the lessee.
Fiscal year	US expression for the period for which companies prepare their annual financial statements. The majority of US companies use 31 December as the fiscal year end, which corresponds with the year end for tax purposes. In the United Kingdom, the expression 'fiscal year' means tax year.
Fixed assets	Assets such as land, buildings and machines which are intended for use on a continuing basis by the business rather than for sale.
Free cash flow (1)	Cash flow after interest, tax, dividends, and capital expenditure, but before acquisitions and share buy-backs.
Free cash flow (2)	Cash flow available to providers of capital after re-investment in the existing business (i.e., Operating cash flow less taxation, less capital expenditure and acquisitions and disposals).
Generally accepted accounting principles (GAAP)	<p>A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board.</p> <p>A technical term in accounting that encompasses the conventions, rules and procedures necessary to define accepted accounting practice at a particular time</p>

Glossary of Accounting Terms

Term	Explanation
Gearing	The proportion of the capital employed of a company that is financed by lenders rather than shareholders.
Going concern	An accounting concept which assumes that a business will continue in operation for the foreseeable future.
Goodwill	The amount paid for a business which exceeds the fair value of the assets acquired.
Gross profit	The difference between the value of sales and the cost of sales.
Group accounts	The financial statements of a group of companies. These are usually presented in the form of consolidated accounts. UK expression for consolidated financial statements.
Historical cost accounting	The conventional system of accounting under which assets are recorded at the original cost of acquiring or producing them.
Holding company	A company which owns or controls other companies. (Control can occur through the ownership of 50 per cent of the voting rights or through the exercise of a dominant influence.)
Income statement	The statement of revenues and expenses of a particular period, leading to the circulation of net income or net profit. The format of the income statement is either 'vertical'/'statement' form or 'horizontal'/'two-sided'/'account' form. The equivalent UK statement is the profit and loss account.
Inflation accounting	A system of accounting which, unlike historical cost accounting, takes account of changing prices.
Insolvency	This occurs when a business is unable to pay debts as they fall due.

Glossary of Accounting Terms

Term	Explanation
Intangible assets	Assets such as goodwill, patents, trademarks, etc. which have no physical or tangible form.
Interim dividend	Dividend payment bases on all the profits of less than a full accounting period.
Interim report	A half-yearly or quarterly report issued by a company to its shareholders. Listed companies are required to publish an interim report.
International Accounting Standards Board (IASB)	The standard setting body set up in 2001 by the International Accounting Standards Committee Foundation, a private sector trust.
Issued share capital	The amount of the share capital of a company that has been issued to shareholders.
Inventories	Raw materials, work-in-progress and goods ready for sale. In the United Kingdom, the word 'stocks' is generally used instead.
Investment properties	Properties held by a business for investment or rental income, rather than for owner-occupation.
Joint venture	An entity in which the reporting company holds an interest on a long-term basis and which is jointly controlled by the reporting company and one or more other ventures under a contractual arrangement.

Glossary of Accounting Terms

Term	Explanation
Liabilities	The amounts owing by a company. Present obligations of an enterprise, arising from past events, the settlement of which is expected to result in an outflow of resources (usually cash). Most liabilities are of known amount and date. They include long-term loans, bank overdrafts and amounts owed to suppliers. There are current and non-current liabilities. The former are expected to be paid within a year from the date of the balance sheet on which they appear. Most measures of liquidity include the total of current liabilities. Net current assets is the difference between the current assets and the current liabilities. Liabilities are valued at the amounts expected to be paid at the expected maturity date. In some cases, amounts that are not quite certain will be included as liabilities (provisions); they will be valued at the best estimate available.
LIFO (last-in, first-out)	One of the methods available under US rules for the calculation of the cost of inventories, in those frequent cases where it is difficult or impossible to determine exactly which items remain or have been used.
Liquidity	The ability of a company to meet its immediate liabilities.
Listed company	A public company listed or quoted on a stock exchange.
Listed investments	Investments which are listed or quoted on a stock exchange.
Loan capital	Alternative name for debt capital, i.e. the amounts borrowed by a company as a long-term source of finance.
Matching	A convention that the expenses and revenues measured in order to calculate the profit for a period should be those that can be related together for that period.
Materiality	An accounting concept which states that the normal rules of accounting concerning valuation or disclosure need only be applied to amounts that are significant or important.

Glossary of Accounting Terms

Term	Explanation
Minority interests	The share capital of a subsidiary company that is not held by the parent company. When consolidated accounts are prepared, 100 per cent of the assets, liabilities, revenues and expenses of all subsidiaries are normally included. However, not all subsidiaries are 100 per cent owned and in such cases a minority of the shares will be left in the ownership of what are known as minority shareholders. The interests of these minority shareholders in the capital of the group (i.e. the minority interests) are shown separately in the consolidated balance sheet.
Net assets	The total of all the assets less liabilities to outsiders. This is equal to the shareholders' funds.
Net current assets	An alternative name for working capital, i.e. the current assets less current liabilities of a company.
Net income	Normal US expression for net profit in UK terminology.
Net profit	Normal UK expression for the excess of all the revenues over all the business for a period. The profit and loss account of a business will show the net profit before tax and the net profit after tax. The profit is then available for distribution as dividends (assuming there is sufficient cash) or for transfer to various reserves. After any dividends on preference shares have been deducted, the figure may be called earnings.
Net realisable value	The amount at which an asset could be sold less the costs incurred in its sale.
Nominal value	Most shares have a nominal or par value. This is little more than a label to distinguish a share from any of a different value issued by the same company. Normally, the shares will be currently exchanged at above the nominal value, and the company will consequently issue any new shares at approximately the market rate. Dividends may be expressed as a percentage of nominal value; and share capital is recorded at nominal value, any excess being recorded as share premium.
Off balance sheet financing	Financing operations in such a way that some or all of the finance does not appear as a balance sheet item.

Glossary of Accounting Terms

Term	Explanation
Operating profit	Profit before the deduction of interest and tax.
Ordinary shares	Shares which entitle the owners to share in the profits remaining after deducting loan interest, taxation and preference share dividends.
Own shares	Shares in a company bought back by the company from its shareholders. In the United States, own shares are called treasury stock.
Parent company	Similar to a holding company, i.e. a company which owns, or has effective control over the activities of, another company (its subsidiary).
Post balance sheet events	Events occurring after the date of the balance sheet but before the accounts are issued. These can be events that require adjustment of the financial statement ('adjusting events') and events that require disclosure but do not require adjustment to the financial statements ('non-adjusting events').
Preference shares	Shares which normally have preference over ordinary shares for payment of dividends, and for repayment of capital if a company is wound up. Preference shares are usually entitled to a fixed rate of dividend.
Private company	A company that is not allowed to issue shares or loan stock to the public.
Profit	The excess of the revenues earned in a period over the costs incurred in earning them.
Profit and Loss Account	The UK expression for the financial statement that summarizes the difference between the revenues and expenses of a period. Such statements may be drawn up frequently for the managers of a business, but a full audited statement is normally only published for each accounting year. The equivalent US expression is income statement; and generally, the IASB also uses this term.

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Term	Explanation
Provision	An amount charged against profit to provide for an expected liability or loss even though the amount or date of the liability or loss is uncertain.
Prudence	An accounting concept which requires that provisions be made for all known liabilities or losses when calculating profit but that any gains or revenues should only be included when realized in cash or near cash (e.g. debtors).
Public company	A company whose shares and loan stock may be publicly traded. A public company must have 'public limited company' (or plc) as part of its name.
Realization convention	A well-established principle of conventional accounting, that gains or profits should only be recognized when they have been objectively realized by some transaction or event. For example, a gain on revaluation is only realized when the asset is sold for cash.
Receivables	The IASB and US expression for amounts of money due to a business; often know as accounts receivable. The UK term is debtors.
Recognition	The process of incorporating an item in a financial statement.
Reducing balance depreciation	A technique of calculating the depreciation charge, usually for machines, whereby the annual charge reduces over the years of an asset's life. A fixed percentage depreciation is charged each year on the cost (first year) or the un-depreciated cost (subsequent years).
Registrar of companies	A government official who is responsible for collecting and arranging public access to the annual reports of all companies.
Related companies	The Companies Act term for what are essentially associated companies.
Replacement cost accounting	A system of accounting in which assets (and related expenses such as depreciation) are valued at what it would cost to replace them.

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Term	Explanation
Reserves	Reserves consist of the accumulated profits that have been retained by a company, plus any surplus from the revaluation of assets, plus any share premium. Reserves belong to shareholders and are part of shareholders' funds.
Retained profits	Profits that have not been paid out as dividends to shareholders, but retained for further investment by the company.
Revaluation	Conventional accounting uses historical COST as the basis for the valuation of ASSETS. However, under IASB and some other rules, it is acceptable to revalue fixed assets annually.
Revaluation reserve	The gain or loss arising from the revaluation of assets.
Rights issue	The issue of new shares by a company to existing shareholders. The 'rights' to buy the new shares are usually fixed at a price below the current market price.
Sales	The figure for sales recorded in the financial statements for a period, including all those sales agreed or delivered in the period, rather than those that are paid for in cash. The sales figure will be shown net of sales taxes (VAT, etc). In the United Kingdom the word turnover is used in the financial statements, although 'sales' is generally used in the books of account.
Segment reporting	The disclosure of sales, profit or assets by line of business or by geographical area.
Share capital	The nominal value of the shares that have been issued by a company.
Share premium	The amount received by a company for its shares that is in excess of their nominal value.
Shareholders' funds	The total of the shareholders' interest in a company. It consists of share capital plus reserves and is equal to the net assets of the company.

Glossary of Accounting Terms

Term	Explanation
Short-term debt	A type of current liability. A loan that is repayable within one year from the date of the balance sheet.
Solvency	The ability to pay debts as they become due.
Statement of total recognized gains and losses	A statement of all the gains and losses (both realized and unrealized) of an accounting period that are attributable to shareholders. Financial Reporting Standard No.3 requires all companies to publish this statement.
Stock	US term for securities of various kinds; for example, common stock or preferred stock (equivalent to ordinary and preference shares in UK terminology).
Stocks and work in progress	This consists of items purchased for resale and includes raw materials required for production, partially completed products (work in progress) and finished products.
Straight-line depreciation	A system calculating the annual depreciation expense of a fixed asset. This method charges equal annual instalments against profit over the useful life of the asset.
Subsidiary	A company that is controlled by another company (a parent company). Control can occur because either more than 50 per cent of the voting rights are owned by another company or because a 'dominant influence' is exercised by another company.
Substance over form	The presentation in financial statements of the underlying economic or commercial substance of a particular transaction, rather than the superficial, strictly legal or technical form of it.
Tangible assets	Normally applied to those fixed assets that have a physical existence, such as land and buildings, plant and machinery.
Total assets	The total of the fixed assets and current assets of a company.

Glossary of Accounting Terms

Term	Explanation
Treasury stock	US expression for a company's shares that have been bought back by the company and not cancelled. The shares are held 'in the corporate treasury'. They received no dividends and carry no votes at company meetings. The UK equivalent term is 'own shares'.
True and fair view	The overriding legal requirement for the presentation of financial statements of companies in the United Kingdom, most of the (British) Commonwealth and the European Union. The nearest US equivalent is 'fair presentation'.
Turnover	The sales revenue of an accounting period.
Unlisted investments	Investments which are not listed on a stock exchange.
Window dressing	Manipulation of financial statements in order to give a misleading or unrepresentative impression.
Working capital	An alternative name for net current assets, i.e. the current assets less current liabilities of a company.
Written down value	The value of assets in the books of a company. This is usually the historical cost less the cumulative amount of depreciation written off at the balance sheet date.
Sources: This glossary is based on glossaries published in Pendlebury and Groves (2001) and Alexander and Nobes (2004)	