CERTIFIED EXPERT IN FINANCIAL & MANAGERIAL ACCOUNTING

Unit 2: Understanding IFRS Reports

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Unit 2: Understanding IFRS Reports

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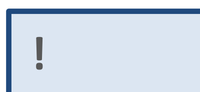
Symbols

Definition

Further Reading


Key Message

Example

Exercise

Video Lecture

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Certified Expert in Financial & Managerial Accounting | Unit 2

Abbreviations

AG	Aktiengesellschaft (German legal form, stock corporation)
bn	Billion
BC	Basis for Conclusions
B/S	Balance Sheet (position)
CEO	Chief Executive Officer
CFO	Chief Financial Officer
Cr	Abbreviation in journal entries for credit entries (“**cr**editor”)
DBO	Defined benefit obligation
Dr	Abbreviation in journal entries for debit entries (“**d**ebto**r**”)
EU	European Union
EUR	Euro
FIFO	First in first out
GAAP	Generally Accepted Accounting Principles
GBP	Pound Sterling
IAS	International Accounting Standard(s)
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IOSCO	International Organization of Securities Commissions
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
ITC	U.S. International Trade Commission

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LIFO	Last in first out
OB	Objectives (Framework)
OCI	Other Comprehensive Income (position)
OHADA	Organisation pour l'Harmonisation en Afrique du Droit des Affaires
P&L	Profit and Loss (position)
PPE	Property, plant and equipment
PV	Present Value
PUCM	Projected unit credit method
QC	Qualitative Characteristics (Framework)
SEC	U.S. Securities and Exchange Commission
SIC	Standard Interpretations Committee
U.K.	United Kingdom
U.S.	United States

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Learning Outcome

Financial reports are the outcome of the financial reporting process. This Unit enables you to read and understand financial statements, a necessary step for analysing them. Understanding IFRS reports is of high practical relevance for several reasons: (1) Top managers should be able to understand how the business model translates into financial statements. (2) Many stakeholders base their economic decision-making on published financial statements; accounting likely will have an impact on cost of capital. (3) In banks, credit decisions require thorough financial statement analysis, in most cases the clients of a bank are not from the financial sector. This Unit uses the example of Volkswagen, a German car manufacturer selling its products worldwide. The interesting feature is that Volkswagen is not only an industrial firm but also has a financial arm, which includes one of Germany's largest banks. This allows us to use Volkswagen as a convenient example both for readers interested in financial reporting issues in industrial firms and in banks.

Learning outcomes will be:

- Understanding the information provided in balance sheet, statement of comprehensive income, cash flow statement and statement of changes in equity
- Familiarity with definitions of assets, liabilities, equity, expenses and income
- Understanding the basic principles when key assets and liabilities are recognised and how they are initially and subsequently measured under IFRS
- Understanding the basic principles when key income and expense items are recognised and how they are measured under IFRS

Key Skills to be learned

- Ability to explain how a business model translates into financial statements
- Ability to precisely communicate with business partner using clearly defined terms
- Assessing the effects of recognition and subsequent measurement on profit and loss and other comprehensive income

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1 Understanding IFRS Reports – Elements of IFRS Financial Statements

A complete set of IFRS financial statements consists of the following elements (IAS 1.10):

Balance sheet

A statement of financial position as at the end of the period, which includes the firm's assets, liabilities and equity.

Statement of comprehensive income

A statement of profit and loss and other comprehensive income for the period. The statement summarises revenues and expenses of the period, some of which are recognised in profit and loss and others in other comprehensive income. IAS 1.7 features a complete list of items that are recognised in other comprehensive income (all other items are recognised in profit or loss). An example for an item that is recognized in other comprehensive income is a revaluation gain arising from the revaluation of property, plant and equipment over and above historical cost. Note that a firm might provide a single table or disclose separate statements (a) of profit and loss and (b) of comprehensive income.

Cash flow statement

This statement informs about cash inflows and outflows and relates them to operating, financing and investing activities of the firm.

Statement of changes in equity

This statement explains why and how the equity position has changed in the current period.

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Notes

These explain significant accounting policies and provide other explanatory information.

Comparative information

Financial statement users might find it useful to compare the financials of the current reporting period with the previous period. IFRS thus forces firms to also include figures of the preceding period. In order to enhance the comparability of current and past financials, the past period is not always reported as it has been in the previous financial statements. Suppose there was a change in accounting standards that becomes applicable in the current period, the firm then may be forced to recalculate figures of the past period to show financials as if the new standard would have already been in force in the past period. Except when IFRSs permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.

Note that other (local) regulation might require additional information to be part of the financial report even though this is not related to IFRS. In Germany, for instance, firms also have to include a management discussion as a mandatory part of financial statements and to present individualized executive compensation figures.

Chapter 1: Exercise 1

1. In which part of the financial statements do we find

   a) the carrying value of property, plant and equipment?
   b) cost of goods sold?
   c) revenues?
   d) cash and cash equivalents available at fiscal-year-end?
   e) the operating cash flow generated in the fiscal year?
   f) the growth in financial income?
   g) which inventory valuation method is used?

h) a detailed summary of transactions with equity holders in the fiscal year?
i) the new fair value and the gain arising from a revaluation of a financial instrument classified as available-for-sale under IAS 39?

2. What is the difference between the balance sheet and the statement of comprehensive income?

Solutions: Please refer to the last chapter.

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2 How a firm's business model is depicted in its financial statements

Scenario: The case of Volkswagen

In the following, we illustrate IFRS financial reports using the example of the 2014 consolidated accounts of Volkswagen AG. Volkswagen is a large German car manufacturer and one of the largest corporate groups in Germany. Volkswagen is an interesting case since the corporate group also includes a large financial institution – Volkswagen Financial Services – allowing us to use their financial statements both for discussing accounting aspects of corporates and financial institutions. The 2014 financial statements were released before it was revealed that some cars had been equipped with so-called "cheat devices" what caused investigations around the world. As of May 2015, the Group maintained 119 production plants in 20 European countries and a further 11 countries in the Americas, Asia and Africa. In 2014, the company had around 600,000 employees and produced, on an average day, around 41,000 vehicles, which were sold in 153 countries.

Background information on Volkswagen's "diesel scandal" including a timeline can be found here: https://www.youtube.com/watch?v=hOTKIZgppbs

Essential questions users of financial statements ask is: What is a firm's **business model**? Whether the business model makes sense is a question accountants usually leave to business strategists, but accounting helps insiders and outsiders in understanding whether a firm is successful with the business model at place or to provide performance measures that help exerting it. It is thus an essential task to understand how a firm's business model is reflected in its financial statements.

Let us consider the case of Volkswagen. Volkswagen does not have an official mission statement (except for a new environmental mission statement "goTOzero") which would give an indication of their exact scope of business. On their website (accessed October 2019), they however say: "With its "TOGETHER – Strategy 2025" future program, the Volkswagen Group is paving the way for the biggest change process in its history: the realignment of one of the best carmakers to become a globally leading provider of sustainable mobility. To achieve that, the Group will be transforming its automotive core business, and will among other things be launching a further 30-plus fully electric cars by 2025, as well as expanding battery technology and autonomous driving as new core

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competences”. This might be interpreted as their main focus being on manufacturing vehicles. Consistently, they describe themselves to be one of the world’s leading automobile manufacturers and the largest carmaker in Europe, also being engaged in several additional lines of business. These include the manufacturing of “diesel engines for marine and stationary applications (turnkey power plants), turbochargers, turbomachinery (steam and gas turbines), compressors and chemical reactors.” It also includes the production of “vehicle transmissions, special gear units for wind turbines, slide bearings and couplings as well as testing systems for the mobility sector.” The Group also “offers a wide range of financial services, including dealer and customer financing, leasing, banking and insurance activities, and fleet management.”

The business of car **manufacturing** means that raw materials are transferred into finished goods, which are then sold to customers. The manufacturing process is characterised by using property, plant and equipment, knowledge and employees as important “input factors” to generate finished goods. Note that these input factors are not fully shown in the balance sheet: in particular, the firm will not show the value of their employees and certain intangible assets – mainly because it is not entirely clear to which extent the firm can ultimately control these assets, hence, the definition criteria of assets are not met in these cases. Accounting standards define what is allowed to be shown in the balance sheet, and they are fairly restrictive regarding a wide range of internally generated intangible assets and human resources. Financial statements are thus somewhat biased towards recording “tangible” assets such as property, plant and equipment (PPE) and inventories in the balance sheet. Any expenditures not recognized in the balance sheet need to be expensed.

2.1 Production

The **production process** gives rise to three important balance sheet (B/S) positions next to cash: intangibles (the required knowledge acquired from third parties or generated from development activities that meet extensive recognition criteria), property, plant and equipment (the non-current resources held for production and administrative purposes) and inventories (including raw materials, work-in-progress and finished goods). The production process as such does not give rise to profits or expenses. Journal entries of purchasing raw materials or property, plant & equipment or transferring raw materials into work-in-progress and work-in-progress into finished goods have the following form (where Dr is a debit entry, Cr is a credit entry and B/S refers to a balance sheet position):

Activity	Typical journal entry	
	Dr	Cr
Buying raw materials for cash	Raw materials (B/S)	Cash (B/S)

Buying property, plant and equipment (PPE)	PPE (B/S, Dr)	Cash (B/S)
Transferring raw materials into work-in-progress in production	Work-in-progress (B/S)	Raw materials (B/S)
Transferring raw materials into finished goods in production	Finished goods (B/S)	Work-in-progress (B/S)

However, investing in production facilities might have some impact on profits because, due to their use in production, assets (particularly fixed assets) will be consumed. This reduction in value (”**asset depletion**”) is captured by planned depreciation and impairments. Unlike depreciation or amortisation, impairments are reductions in value which have not been anticipated and that are conditional to the occurrence of adverse events. Depreciation, amortisation and impairments give rise to journal entries such as the following (P&L refers to a position in profit or loss):

Activity	**Typical journal entry**	
	Dr	**Cr**
Recognising the expected decrease in physical economic resources (PPE) due to the usage of assets by depreciation	Depreciation Expense (P&L)	PPE (B/S)
Recognising the expected decrease in intangible economic resources due to the usage of assets by amortisation	Amortization Expense (P&L)	Intangibles (B/S)
Recognising the unexpected decrease in economic resources (here: PPE) due to damages or other incidences by impairment	Impairment Expense (P&L)	PPE (B/S)

Obviously, the production of goods or services gives rise to certain expenditures. While these expenditures would usually be recorded as expenses in the profit and loss statement (as we have seen for depreciation, amortisation and impairment above), they might also be allocated to the production cost of inventories (usually finished goods). Two examples illustrate how expenses can be capitalised:

Activity	**Typical journal entry**	
	Dr	**Cr**
Recognition of personnel expenditures (initially recognised as personnel expenses) in production cost of finished goods	Finished goods (B/S)	Personnel expenses (P&L)
Allocating the depreciation of a machine (initially recognised as an expense in P&L) used in production to the production cost of finished goods	Finished goods (B/S)	Depreciation Expense (P&L)

2.2 Generating revenues: Sales and leasing

Volkswagen **sells finished goods** – the vehicles –directly to customers (using e.g. their own dealer network). A common transaction would be to sell a car in exchange for cash. This would give rise to the following type of journal entry, which reflects that cash is received and revenues are recognised while at the same time we "consume" our finished good at place, contemporaneously recognised as an expense and a reduction in inventories:

Activity	**Typical journal entry**	
	Dr	**Cr**
Selling a car in consideration for cash	Cash (B/S)	Revenues (P&L)
Recognising the reduction in stock	Cost of Goods Sold (P&L)	Finished goods (B/S)

Of course, Volkswagen might agree that the cars are paid at a later point in time by its customers, this gives rise to customer financing and will result in journal entries of the following form once the transactions are entered:

Activity	Typical journal entry	
	Dr	Cr
Recognising credit sales	Receivable (B/S)	Revenues (P&L)
Recognising the reduction in stock	Cost of Goods Sold (P&L)	Finished goods (B/S)
Collecting proceeds from customer at a later point in time	Cash (B/S)	Receivable (B/S)

Another form of generating revenues with finished goods is **leasing**.
In an **operating lease** agreement in which Volkswagen is the lessor, the vehicles remain in Volkswagen's balance sheet and revenues are earned via rental payments from customers on a monthly or an annual basis. This does neither give rise to customer financing nor sales revenues since ownership is not transferred. It is rather the right of use that is transferred to customers for a limited period of time. A lease contract is somewhat similar to rental contracts, but there are some specific features such as being non-cancellable throughout the lease term. Since operating lease agreements are likely more long-term, the nature of the asset changes: The current asset (finished good in inventories) now becomes a non-current item which falls under the definition of property, plant and equipment. Since "own stock" which is now used as a non-current item is still somewhat different from other positions in property, plant and equipment, many firms – including Volkswagen – tend to show them in a separate line item in the balance sheet. Very often, such assets are referred to as a lease asset, not to be confused with items Volkswagen itself leases from third parties. This gives rise to journal entries of the following form:

Activity	Typical journal entry	
	Dr	Cr
Transferring current stock into lease assets	Lease assets (B/S)	Finished goods (B/S)
Recognising lease payments as a revenue	Cash (B/S)	Revenues from leasing (P&L)

Under a **finance lease** agreement, risks and rewards of ownership are transferred to a customer. In a classical finance lease setting, revenues again only arise from earned lease payments. The firm then shows a receivable reflecting the expected payments from customers over the lease term. It thus again records a receivable which reflects both

interest and redemption paid by the customer over the whole lifetime of the lease agreement. This gives rise to journal entries of the following form:

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Activity	Typical journal entry	
	Dr	Cr
Entry at inception of the finance lease agreement (leasing firm)	Receivables (B/S)	Finished goods (B/S)
The firm now receives lease payments (cash) over the lease term. These payments reduce total receivables, but are also, in part, recognised as revenues from leasing	Cash (B/S, Dr)	Receivables (B/S) Revenues (P&L)

Also Volkswagen leases out cars under finance lease agreements. Unlike in the situation discussed above, Volkswagen has, as a manufacturer of cars, also to recognize sales revenues at the commencement of a finance lease. Volkswagen will thus recognize revenues under finance lease agreements similar to revenue recognition in the case of outright sales if – and only if –risks and rewards of ownership have been transferred to the customer:

Activity	Typical journal entry	
	Dr	Cr
Entry at inception of the finance lease agreement for manufacturers/sellers	Receivables (B/S)	Revenues (P&L)
	Cost of goods sold (P&L)	Finished goods (B/S)
The firm now receives lease payments (cash) over the lease term. These payments reduce total receivables, but are also, in part, recognised as income from leasing	Cash (B/S)	Receivables (B/S) Finance income (P&L)

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2.3 Dealing with risk

Selling products and services gives rise to two different risks: The first is that customers might be unsatisfied with the products and services. This is an important issue since many car sellers give guarantees (partly because law requires them to do so, but sometimes also on a voluntary basis). Suppose that it turns out that there was an issue in the production of a specific model. The manufacturer might be obliged to call all sold cars affected by the problem to the maintenance shop. Since this risk is entered at the point in time cars are sold, it might turn out that any profit generated with selling the car was, in fact, overstated. To account for such risk and to assure a matching of revenues and expenses, the manufacturer builds up provisions once products are sold. This is done via journal entries such as the following:

Activity	**Typical journal entry**	
	Dr	**Cr**
Setting-up a provision:	Expense for provisions (P&L)	Provisions (B/S)
Using a provision when Volkswagen learns that something is wrong with cars	Provisions (B/S)	Cash (Dr)
Derecognising a provision because the firm concludes the obligation no longer exists and has not been needed	Provisions (B/S)	Other operating income (P&L)

Note that manufactures also might have vehicles on their own balance sheet (finished goods in inventories or lease assets). For these assets, no provisions are set up, because no outflow of economic resources to third-parties is expected. Rather, an impairment needs to be recognized in case of any detected problem.

The second risk is that some receivables from customer (or dealer) financing might turn out to be uncollectible. Volkswagen indeed gives loans to some of its customers and dealers. Anticipating some of them to be uncollectible is essentially what also banks do when granting loans: In the financial sector, this exercise is known as loan loss provisioning. Usually, firms create allowances for amounts within receivables expected to be uncollectible (implying that the net value of a receivable is below its gross value):

Activity	Typical journal entry	
	Dr	Cr
Creating a loan loss provision, also called an allowance for bad debt	Expense for loan losses (P&L)	Allowances (B/S)
Using loan loss provisions in case a customer fails to pay, the loan is written-off without any effect on profit or loss	Allowances (B/S)	Receivables (B/S)

2.4 Financing activities

To finance its operating activities, a firm can raise equity or debt. Raising capital, of course, has a cost: Firms need to pay interest on debt, and they might be expected to pay dividends or generate other benefits to equity holders. The basic journal entries for financing activities would be as follows:

Activity	Typical journal entry	
	Dr	Cr
Taking deposits in the financial services business (requires a banking licence in most jurisdictions)	Cash (B/S)	Financial liabilities, deposits (B/S)
Taking a loan from a bank	Cash (B/S)	Financial liabilities, loans (B/S)
Raising money by issuing commercial papers and notes	Cash (B/S)	Financial liabilities, commercial papers and notes (B/S)

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Issuing common stock at par value	Cash (B/S)	Subscribed capital (B/S)
Issuing common stock above par value	Cash (B/S)	Subscribed capital (B/S) Capital reserves (B/S)
Issuing common stock below par value	Transaction not allowed in most jurisdictions.	
Increase in share price of common stock outstanding	Not recognised in financial statements.	
Decrease in share price of common stock outstanding	Not recognised in financial statements.	
Paying dividends	Retained earnings (B/S)	Cash (B/S)

When a firm has a liability, it usually pays interest and it may or may not annually amortise the liability. Suppose the nominal amount of a liability is 100 to be paid back after 5 years. The annual rate agreed on in the contract is 10. We can distinguish three cases, depending on the firm's creditworthiness:

- *Case 1*: The firm received 100 in exchange for entering the debt contract, the issue was "at par", i.e. equal to the nominal amount. In this case, the effective interest rate is 10 per cent and no debt is amortised. In all years, the liability has a value of 100 in the balance sheet. Also, we need to recognise interest expense of 10 in all years, irrespective of whether the payment already took place.

Activity	**Typical journal entry**	
	Dr	**Cr**
Recognising an expense for interest paid for financial liabilities issued at par value (without amortisation)	Interest Expense (P&L)	Cash (B/S)

Recognising an expense for interest not yet paid for financial liabilities issued at par value (without amortisation)	Interest Expense (P&L)	Accounts payable (B/S)

- *Case 2*: The firm received less than 100 in exchange for entering the debt contract, the issue was "below par", i.e. lower than the nominal amount. The effective interest is higher than 10 per cent. The liability is initially recognised with a value below 100, but 100 need to be paid back after 5 years. Since the interest expense is higher than the payment of 10, the difference is used to increase the value of the liability. The book value of the liability is increasing in each year and arrives at 100 after 5 years.

Activity	**Typical journal entry**	
	Dr	**Cr**
Recognising an expense for interest paid for financial liabilities issued below par value	Interest expense (P&L)	Cash (B/S) Financial liability (B/S)

- *Case 3*: The firm receives more than 100 in exchange for entering the debt contract, the issue was "above par", i.e. higher than the nominal amount. The effective interest is lower than 10 per cent. The liability is initially recognised with a value above 100, but only 100 need to be paid back after 5 years. Since the interest expense is lower than the payment of 10, the difference is used to amortise the liability. The book value of the liability is decreasing in each year and arrives at 100 after 5 years.

Activity	**Typical journal entry**	
	Dr	**Cr**
Recognising an expense for interest paid for financial liabilities issued above par value	Interest expense (P&L) Financial liability (B/S)	Cash (B/S)

Mature and healthy firms might generate substantial **surplus funds**. To the extent these funds are not needed for operating or investing purposes, these can be distributed to equity holders in form of share buybacks or dividends. An alternative is to take advantage from surplus funds by repaying liabilities. Finally, surplus funds can also be used to invest into financial assets that generate financial income. A special case is the investment in equity instruments of other firms that grant significant influence or even control rights (see Section 1.3.4). The basic journal entries would be as follows:

Activity	**Typical journal entry**	
	Dr	**Cr**
Repayment of a financial liability	Financial liability (B/S)	Cash (B/S)
Share buyback(firms are not allowed to hold acquired own equity instruments as financial assets according to IAS 32[1])	Equity (B/S)	Cash (B/S)
Investment of surplus cash in financial instruments at fair value through profit or loss	Financial instruments at fair value through profit or loss (B/S)	Cash (B/S)
Recognising an increase in fair value of financial instruments at fair value through profit or loss	Financial instruments at fair value through profit or loss (B/S)	Other financial income (P&L)

[1] Firms are not allowed to hold acquired own equity instruments as financial assets in their own balance sheet (see IAS 32). The reason is that the value of a firm's asset shall not depend on its own market value of equity. Hence, own equity instruments held by the firm reduce a firm's equity position (i.e., this part of equity is not "outstanding").

Recognising a decrease in fair value of financial instruments at fair value through profit or loss	Other financial expense (P&L)	Financial instruments at fair value through profit or loss (B/S)
Investment of surplus cash in financial assets accounted for under the OCI option	Financial assets (OCI) (B/S)	Cash (B/S)
Recognising an increase in fair value of financial instruments accounted for under the OCI-option	Financial assets (OCI) (B/S)	Revaluation gains (OCI)
Investment of surplus cash in financial instruments at amortised cost	Financial instruments (B/S)	Cash (B/S)
Interest income on financial instruments at amortised cost without amortisation	Cash (B/S)	Interest income (P&L)
Investments in other firms that give rise to significant influence but not to control	Equity accounted investments	Cash (B/S)

A special case is the investment in equity instruments of other firms that grant significant influence or even control rights. Such investments are not treated as financial instruments once the firm maintains a significant influence or even full control over the investee. In this situation, the investee is either accounted for under the so-called equity method or fully consolidated (more details will follow).

2.5 Conclusions

Our brief summary helps us to understand how the business model of Volkswagen will affect some basic positions in the balance sheet and the profit and loss statement. We have also seen that the cash position is affected by the business transactions and that Volkswagen's business model will involve some basic financial services, mainly financing customers and dealers. The following text is structured along the elements of financial statements outlined above. We will mainly take a closer look at Volkswagen's balance

sheet, its statement of comprehensive income and its cash flow statement and the respective notes which give us additional insights.

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