

Level : BS / PGD

IFRSS FOR SMES

CODE: 5590

UNITS: 1–9



**Department of Commerce
Faculty of Social Sciences & Humanities
Allama Iqbal Open University, Islamabad**

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LEVEL PGD/ BS

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**DEPARTMENT OF COMMERCE
FACULTY OF SOCIAL SCIENCES & HUMANITIES
ALLAMA IQBAL OPEN UNIVERSITY
ISLAMABAD**

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FOREWARD

It is a great pride that the Department of Commerce at Allama Iqbal Open University (AIOU) introduces this comprehensive course book, International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs), developed for students of the BS Accounting & Finance and PGD programs. As Pakistan's leading institution of open and distance learning, AIOU remains dedicated to providing high-quality academic resources that meet international standards while addressing the practical needs of students in business, commerce, and finance.

In today's fast-changing global economy, where transparency, accountability, and comparability of financial information are essential, the IFRS for SMEs provides a simplified yet solid framework designed for entities without public accountability. This book has been thoughtfully designed to offer a clear understanding of the principles, applications, and implications of IFRS for SMEs, with a focus on its adoption and implementation in Pakistan. The course highlights the differences between full IFRS and IFRS for SMEs and offers practical insights into financial reporting practices relevant to small and medium-sized businesses, which are the backbone of Pakistan's economy.

The book is divided into nine units, each carefully designed to guide learners through the essential concepts. From the nature and objectives of financial statements to recognition, measurement, and disclosure requirements, the material emphasizes a clear understanding and practical use. To strengthen learning, real-world examples from the Pakistani business environment and self-assessment questions are included, helping students connect theory with practice and prepare confidently for professional and academic evaluations.

This resource reflects the collaborative efforts of subject specialists, reviewers, and faculty members, whose dedication has maintained the academic rigor and relevance of the content. I sincerely thank all contributors who played a vital role in developing this book.

I firmly believe that IFRS for SMEs will be a valuable resource for students, educators, and professionals, fostering deeper analytical skills, critical thinking, and professional growth. We hope learners will approach this course with enthusiasm and benefit from the knowledge and skills it provides, enabling them to contribute effectively to Pakistan's financial sector and confidently compete in the global market. At AIOU, we continue to pursue academic excellence and remain dedicated to empowering our students with knowledge that fosters innovation, professional development, and success.

Prof Dr. Nasir Mahmood
(Vice-Chancellor)

MESSAGE FROM THE DEAN OF THE FACULTY

It is a great honour for us to present this e-course book “International Financial Reporting Standard for Small and Medium-sized Entities” (IFRS for SMEs), developed for the Accounting and Finance programs at AIOU. This book offers a simplified yet globally recognized framework for financial reporting, tailored to small and medium-sized enterprises that play a vital role in Pakistan’s economy. Comprising nine well-structured units, it integrates theoretical knowledge with practical applications, with a particular focus on the local business environment. By aligning international standards with national needs, the book enhances our students’ analytical skills, professional competence, and critical thinking. It reflects our faculty’s commitment to academic excellence, innovation, and quality education. I am confident that this resource will equip our learners with the knowledge and confidence essential to meet the challenges of today’s competitive financial world and to contribute meaningfully to the profession.

I extend my best wishes to our dear students for their academic and professional success.

Prof. Dr. Abdul Aziz Sahir
Dean, Faculty of Social Sciences & Humanities
Allama Iqbal Open University

INTRODUCTION TO THE COURSE

This course provides a comprehensive understanding of the International Financial Reporting Standards (IFRS) for Small and Medium-sized Enterprises (SMEs) (Course Code: 5590). It is specifically designed for students of BS Accounting & Finance, Master of Commerce, and the Postgraduate Diploma (PGD) programs at Allama Iqbal Open University, Islamabad, under the Open Distance Learning (ODL) system. The course is organized into nine well-structured units, each focusing on a fundamental aspect of SME financial reporting. Through these units, learners will acquire the knowledge, analytical skills, and practical insights necessary to apply IFRS standards effectively in real-world SME contexts.

Unit 1 introduces the Preface to IFRS for SMEs, outlining the role of the International Accounting Standards Board (IASB), the authority of the standards, their organization, and their adoption in different jurisdictions. It explains how IFRS for SMEs is simplified compared to full IFRS, making it more suitable for smaller entities.

Unit 2 discusses Concepts and Pervasive Principles, covering fundamental accounting concepts, qualitative characteristics, recognition, and measurement of assets, liabilities, income, and expenses. It also emphasizes accrual basis accounting and the importance of prudence, comparability, and transparency in reporting.

Unit 3 focuses on Financial Statement Analysis, explaining the structure and presentation of the statement of financial position, income statement, statement of cash flows, and notes. It demonstrates how proper analysis helps in decision-making and ensures fair presentation under IFRS for SMEs.

Unit 4 addresses Inventories, including recognition, measurement, cost components, and valuation techniques such as FIFO and weighted average. It highlights impairment rules, expense recognition, and necessary disclosures to maintain accuracy and compliance.

Unit 5 explores Revenue, guiding recognition principles, measurement methods, and disclosures for goods, services, and other income. It ensures consistency and reliability in reporting revenue streams.

Unit 6 covers Property, Plant, and Equipment (PPE), explaining recognition, measurement, depreciation, impairment, and revaluation methods. It highlights the significance of long-term asset management for SMEs.

Unit 7 discusses Intangible Assets Other than Goodwill, including recognition,

valuation, amortization, and impairment of assets such as patents, trademarks, and software. It explains their impact on financial reporting and enterprise value.

Unit 8 examines Related Party Disclosures, focusing on the identification of related parties, disclosure of relationships, transactions, and balances. This promotes transparency and prevents conflicts of interest.

Unit 9 concludes with Miscellaneous Topics, including provisions, contingencies, employee benefits, collections, contributions receivable, and transition to IFRS for SMEs. It also stresses comprehensive disclosures to ensure accountability and compliance.

By progressing through these nine units, learners will build a solid foundation in IFRS for SMEs, enabling them to prepare, analyse, and present financial statements that are transparent, reliable, and in alignment with international practices. While every effort has been made to present an accurate and error-free study guide, there is always room for improvement. Feedback and suggestions for enhancing the content and quality of this course are highly appreciated.

I would like to extend my gratitude to Prof. Dr. Abdul Aziz Sahir, Dean of the Faculty of Social Sciences & Humanities, Prof. Dr. Syed Muhammad Amir Shah, Chairman of the Department of Commerce, and Mr. Moazzam Ali, Assistant Professor, for their invaluable guidance and support in the development of this course.

Asia Batool
Leccturer
Department of Commerce

COURSE OBJECTIVES

The objectives of this course can be enumerated as follows:

- Understand the purpose, scope, and structure of the IFRS for SMEs.
- Comprehend the fundamental accounting concepts and pervasive principles underlying SME financial reporting.
- Develop the skills to analyse financial statements and assess the financial health of SMEs.
- Master inventory measurement, costing techniques, and valuation methods in an SME context.
- Grasp revenue recognition principles, measurement methods, and related disclosure requirements.
- Understand the accounting treatment and valuation methods for property, plant, and equipment.
- Learn the recognition and measurement of intangible assets and their impact on financial reporting.
- Explore the accounting for liabilities, employee benefits, and financial instruments under IFRS for SMEs.
- Examine miscellaneous topics, including provisions, collections, and comprehensive disclosure practices.

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Unit- 1

PREFACE TO THE IFRS FOR SMES

Complied by: Asia Batool
Reviewed by: Prof. Dr. S.M. Amir Shah

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INTRODUCTION

The IFRSs for SMEs were developed by the IASB to provide a simplified financial reporting framework for small and medium-sized enterprises without public accountability. It ensures transparency, consistency, and comparability while reducing complexity and costs. Unlike full IFRS, which is designed for large entities, IFRS for SMEs addresses the specific needs of smaller businesses. The standard is structured into sections covering various accounting topics for easier implementation. It is periodically updated to remain relevant and practical for SMEs. The SECP in Pakistan has adopted IFRS for SMEs, ensuring compliance with international practices. This adoption supports SMEs by improving financial reporting quality and reducing regulatory burdens.

OBJECTIVES

After this unit, you will be able to understand these concepts:

- To understand the role and importance of IFRS for SMEs in financial reporting.
- To differentiate IFRS for SMEs from full IFRS and explain its advantages.
- To explore the application, structure, and periodic updates of the standard.
- To examine the adoption and implementation of IFRS for SMEs in Pakistan.
- To understand financial reporting requirements for SMEs and their impact.
- To analyse the challenges and benefits of adopting IFRS for SMEs.

1.1. PREFACE TO IFRS

1.1.1. The IASB

The International Accounting Standards Board (IASB) is an independent, international body responsible for developing and issuing International Financial Reporting Standards (IFRS). The IASB's primary objective is to create a single set of high-quality, understandable, and enforceable global accounting standards. These standards aim to bring transparency, accountability, and efficiency to financial markets worldwide. The International Accounting Standards Board (IASB) was established in 2001 as part of the International Accounting Standards Committee (IASC) Foundation. In 2010, the IASC Foundation was renamed the IFRS Foundation.

- i. The governance of the IFRS Foundation rests with 22 Trustees. The Trustees' responsibilities include appointing the members of the IASB and associated councils and committees, as well as securing financing for the organization.

The objectives of the IASB are:

- (a) to develop, in the public interest, a single set of high-quality, understandable, enforceable, and globally accepted financial reporting Standards based on clearly articulated principles. These Standards require high-quality, transparent, and comparable information in financial statements and other financial reporting to help investors, other participants in the world's various capital markets, and other financial information users make economic decisions.
- (b) to promote the use and rigorous application of those Standards.
- (c) In fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings.
- (d) to promote and facilitate the adoption of its Standards.

Approval of Standards and related documents, such as, Exposure Drafts and other discussion documents, is the responsibility of the IASB.

Example from Pakistan: The Securities and Exchange Commission of Pakistan (SECP) has adopted IFRS for listed companies to ensure consistency and comparability of financial statements with global markets. This adoption aligns with the IASB's mission to harmonize accounting practices.

1.1.2. Full International Financial Reporting Standards (full IFRS)

Full IFRS refers to the comprehensive set of accounting standards issued by the IASB for use by publicly accountable entities. These standards are designed to meet the needs of capital markets and provide detailed guidance for complex transactions.

- i. The IASB achieves its objectives primarily by developing and publishing Standards and promoting their use in general-purpose financial statements and other financial

reporting. Other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions. The term 'financial reporting' encompasses general-purpose financial statements plus other financial reporting.

- ii. Full IFRS sets out recognition, measurement, presentation, and disclosure requirements dealing with transactions and events that are important in general-purpose financial statements. They may also set out such requirements for transactions, events, and conditions that arise mainly in specific industries. Full IFRS is based on the Conceptual Framework, which addresses the concepts underlying the information presented in general-purpose financial statements. The objective of the Conceptual Framework is to facilitate the consistent and logical formulation of full IFRS. It also provides a basis for the use of judgment in resolving accounting issues. *Example from Pakistan:* Large Pakistani companies like Engro Corporation and Habib Bank Limited (HBL) use full IFRS to prepare their financial statements, as they operate in global markets and require compliance with international standards.

1.1.3. General purpose financial statements

General-purpose financial statements are financial reports intended to meet the information needs of users who cannot demand customized reports. These statements provide a fair presentation of an entity's financial position, performance, and cash flows.

- i. The IASB's Standards are designed to apply to general-purpose financial statements and other financial reporting of all profit-oriented entities. General-purpose financial statements are directed toward the common information needs of a wide range of users, such as shareholders, creditors, employees, and the public at large. The objective of financial statements is to provide information about an entity's financial position, performance, and cash flows that is useful to those users in making economic decisions.
- ii. General-purpose financial statements are those directed to the general financial information needs of a wide range of users who are not in a position to demand reports tailored to meet their information needs. General purpose financial statements include those that are presented separately or within another public document, such as an annual report or a prospectus.

Example from Pakistan: Small and medium-sized enterprises (SMEs) in Pakistan, such as local textile manufacturers, prepare general-purpose financial statements to provide information to banks, tax authorities, and potential investors.

1.1.4. The IFRS for SMEs

The IFRS for SMEs is a simplified version of the full IFRS, tailored for small and medium-sized entities that do not have public accountability. It reduces the complexity and cost of financial reporting while maintaining the quality and transparency of financial information.

- i. The IASB develops and issues a separate Standard intended to apply to the

general-purpose financial statements of, and other financial reporting by, entities that in many countries are referred to by a variety of terms, including small and medium-sized entities (SMEs), private entities and non-publicly accountable entities. That Standard is the *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs). The IFRS for *SMEs* is based on full IFRS with modifications to reflect the needs of users of SMEs' financial statements and cost-benefit considerations.

- ii. The term small and medium-sized entities used by the IASB is defined and explained in Section 1, Small and Medium-sized Entities. Many jurisdictions around the world have developed their definitions of SMEs for a broad range of purposes, including prescribing financial reporting obligations. Often, those national or regional definitions include quantified criteria based on revenue, assets, employees or other factors. Frequently, the term SMEs is used to mean or to include very small entities without regard to whether they publish general-purpose financial statements for external users.
- iii. SMEs often produce financial statements only for the use of owner-managers or only for the use of tax authorities or other governmental authorities. Financial statements produced solely for those purposes are not necessarily general-purpose financial statements.
- iv. Tax laws are specific to each jurisdiction, and the objectives of general-purpose financial reports differ from the objectives of reporting taxable profit. Thus, financial statements prepared in conformity with the IFRS for SMEs are unlikely to comply fully with all of the measurements required by a jurisdiction's tax laws and regulations. A jurisdiction may be able to lessen the 'dual reporting burden' on SMEs by structuring tax reports as reconciliations from the profit or loss determined by the IFRS for SMEs and by other means.

Example from Pakistan: A medium-sized dairy farm in Punjab, Pakistan, may use the IFRS for SMEs to prepare its financial statements, as it does not have public accountability and does not need the extensive disclosures required by full IFRS.

1.1.5. Authority of the IFRS for SMEs

The IFRS for SMEs derives its authority from its adoption by national regulatory bodies. While the IASB issues the standard, its implementation depends on local jurisdictions recognising it as a valid framework.

Example from Pakistan: The SECP has recognised the IFRS for SMEs as the applicable standard for non-publicly accountable entities in Pakistan, giving it legal authority for SMEs.

1.1.6. Organisation of the IFRS for SMEs

The IFRS for SMEs is organised into sections, each addressing a specific accounting topic. The structure is designed to be user-friendly, with clear guidance and reduced disclosure requirements compared to full IFRS.

The IFRS for SMEs is organised by topic, with each topic presented in a separate numbered section. Cross-references to paragraphs are identified by section number followed by paragraph number.

Example from Pakistan: A small software development company in Karachi can easily

navigate the IFRS for SMEs to find relevant guidance on revenue recognition, as the standard is organized logically and avoids unnecessary complexity.

1.1.7. Maintenance of the IFRS for SMEs

The IASB is responsible for maintaining and updating the IFRS for SMEs. Updates are made periodically to address emerging issues and ensure the standard remains relevant and practical for SMEs.

Example from Pakistan: If the IASB introduces changes to the IFRS for SMEs, the SECP will issue notifications to Pakistani SMEs to ensure they adopt the updated standards.

- i. The IASB expects to propose amendments to the IFRS for SMEs by publishing an omnibus Exposure Draft periodically, but not more frequently than approximately once every three years. In developing those Exposure Drafts, it expects to consider new and amended full IFRS Standards as well as specific issues that have been brought to its attention regarding the application of the IFRS for SMEs. On occasion, the IASB may identify an urgent matter for which amendment of the IFRS for SMEs may need to be considered outside the periodic review process. However, such occasions are expected to be rare.
- ii. Until the IFRS for SMEs is amended, any changes that the IASB may make or propose concerning full IFRS do not apply to the IFRS for SMEs. The IFRS for SMEs is a stand-alone document. SMEs shall not anticipate or apply changes made in full IFRS before those changes are incorporated into the IFRS for SMEs unless, in the absence of specific guidance in the IFRS for SMEs, an SME chooses to apply guidance in full IFRS, and those principles do not conflict with requirements in the hierarchy.

1.2. Preface to Small and Medium-sized Entities

1.2.1. Intended scope of this Standard

The IFRS for SMEs is intended for entities that do not have public accountability and publish general-purpose financial statements for external users. Publicly accountable entities, such as listed companies, are required to use full IFRS.

Example from Pakistan: A family-owned restaurant chain in Lahore, which is not listed on the stock exchange, falls within the scope of the IFRS for SMEs, as it does not have public accountability.

1.2.2. Description of small and medium-sized entities

Small and medium-sized entities (SMEs) are defined as entities that do not have public accountability and are not required to publish general-purpose financial statements for external users. These entities typically have simpler organisational structures and fewer resources than larger entities.

- a. Small and medium-sized entities are entities that:
 - i. do not have **public accountability**, and

- ii. Publish **general-purpose financial statements** for external users.
 - iii. Examples of external users include **owners** who are not involved in managing the business, existing and potential creditors, and credit rating agencies.
 - iv. An entity has public accountability if: its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
 - v. It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (most banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks would meet this second criterion).
- b. Some entities may also hold assets in a fiduciary capacity for a broad group of outsiders because they hold and manage financial resources entrusted to them by clients, customers or members not involved in the management of the entity. However, if they do so for reasons incidental to a primary business (as, for example, may be the case for travel or real estate agents, schools, charitable organizations, co-operative enterprises requiring a nominal membership deposit and sellers that receive payment in advance of delivery of the goods or services such as utility companies), that does not make them publicly accountable.
 - c. If a publicly accountable entity uses this Standard, its financial statements shall not be described as conforming to the IFRS for SMEs—even if law or regulation in its jurisdiction permits or requires this Standard to be used by publicly accountable entities.
 - d. A **subsidiary** whose **parent** uses **full IFRS**, or that is part of a consolidated **group** that uses full IFRS, is not prohibited from using this Standard in its own financial statements if that subsidiary by itself does not have public accountability. If its financial statements are described as conforming to the *IFRS for SMEs*, it must comply with all of the provisions of this Standard.
 - e. A parent entity (including the ultimate parent or any intermediate parent) assesses its eligibility to use this Standard in its **separate financial statements** based on its status without considering whether other group entities have, or the group as a whole has, public accountability. If a parent entity by itself does not have public accountability, it may present its separate financial statements in accordance with this Standard (see Section 9 *Consolidated and Separate Financial Statements*), even if it presents its **consolidated financial statements** in accordance with full IFRS or another set of generally accepted accounting principles (GAAP), such as its national accounting standards. Any financial statements prepared in accordance with this Standard shall be clearly distinguished from financial statements prepared in accordance with other requirements.

Example from Pakistan: A small-scale textile exporter in Faisalabad, employing fewer than 250 people and not listed on the stock exchange, qualifies as an SME under this definition. Such entities benefit from the simplified reporting requirements of the IFRS for SMEs.

Key Takeaways for the Pakistani Context

- The IFRS for SMEs is particularly relevant for Pakistan's SME sector, which forms the backbone of the economy. By adopting this standard, Pakistani SMEs can reduce the cost and complexity of financial reporting while maintaining transparency and credibility.
- Examples like small textile manufacturers, dairy farms, and software companies illustrate how the IFRS for SMEs can be applied in various industries across Pakistan.
- The SECP's recognition of the IFRS for SMEs ensures that Pakistani SMEs have a clear and authoritative framework for financial reporting.

Summary

This unit covers the IFRS for SMEs, a simplified financial reporting standard developed by the IASB for small and medium-sized enterprises that do not have public accountability. It highlights the differences between full IFRS and IFRS for SMEs, emphasising the latter's reduced complexity and cost-effectiveness. The unit explains the authority, organization, and maintenance of the standard, along with its applicability in different jurisdictions, including Pakistan. It discusses how IFRS for SMEs helps businesses ensure transparency, comparability, and compliance with global financial standards. Examples from Pakistan, such as SMEs in textiles, dairy, and software industries, illustrate its real-world implementation. The unit also outlines the periodic updates to the standard by the IASB to keep it relevant. Additionally, it explains the benefits and challenges SMEs face in adopting IFRS for financial reporting.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015

<https://www.ifrs.org/projects/completed-projects/2015/2015-comp>

Unit- 2

**CONCEPTS AND PERVASIVE
PRINCIPLE**

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INTRODUCTION

Financial statements are vital for SMEs as they provide insights into their financial health, performance, and decision-making. This unit introduces the essential principles governing financial statements, ensuring their accuracy and usefulness. It explores key financial concepts, including recognition, measurement, and reporting. The unit also emphasises the qualitative characteristics that enhance financial data reliability. It provides a structured approach to understanding assets, liabilities, income, and expenses. These principles form the foundation for preparing transparent and consistent financial statements.

OBJECTIVES

After this unit, you will be able to understand these concepts:

- Understand the fundamental principles governing financial statements for SMEs.
- Learn the qualitative characteristics that enhance the relevance and reliability of financial reports.
- Gain insight into financial position, performance, and measurement principles.
- Comprehend the application of accrual basis accounting in financial reporting.
- Analyse recognition criteria for assets, liabilities, income, and expenses.
- Apply financial principles to enhance decision-making and accountability in business.

Concepts and Pervasive Principles

2.1 Scope of this section

This section describes the objective of financial statements of small and medium-sized entities (SMEs) and the qualities that make the information in the financial statements of SMEs useful. It also sets out the concepts and basic principles underlying the financial statements of SMEs.

2.2 Objective of financial statements of small and medium-sized entities

- i. The objective of financial statements of a small or medium-sized entity is to provide information about the financial position, performance, and cash flows of the entity that is useful for economic decision-making by a broad range of users of the financial statements who are not in a position to demand reports tailored to meet their information needs.
- ii. Financial statements also show the results of the stewardship of management—the accountability of management for the resources entrusted to it.
An example of these objectives in the context of a small or medium-sized entity (SME) in Pakistan could be a local manufacturing business.
 - a. **Financial Position & Decision-Making:** A textile SME prepares financial statements showing its assets (machinery, inventory, cash) and liabilities (bank loans, supplier dues). Investors, banks, and suppliers use this information to decide whether to invest, lend, or extend credit. Since these stakeholders cannot demand customised reports, they rely on standardised financial statements for decision-making.
 - b. **Stewardship & Accountability:** The company's financial statements also reflect how well management has utilised resources. If the profit margin has increased, it shows that management has effectively controlled costs and improved efficiency. If debt levels have risen without a corresponding increase in assets or sales, it may indicate poor financial management. This accountability ensures transparency for shareholders, lenders, and regulatory authorities.

2.3 Qualitative characteristics of information in financial statements

2.3.1 Understandability

The information provided in financial statements should be presented in a way that makes it comprehensible to users who have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information with reasonable diligence. However, the need for understandability does not allow relevant information to be omitted because it may be too difficult for some users to understand

2.3.2 Relevance

The information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of relevance when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

2.3.3 Materiality

Information is material—and therefore has relevance—if its omission or misstatement could influence the economic decisions of users made based on the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. However, it is inappropriate to make or leave uncorrected, immaterial departures from the IFRS for SMEs to achieve a particular presentation of an entity's financial position, financial performance, or cash flows.

2.3.4 Reliability

The information provided in financial statements must be reliable. Information is reliable when it is free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent. Financial statements are not free from bias (ie not neutral) if, by the selection or presentation of information, they are intended to influence the making of a decision or judgment to achieve a predetermined result or outcome.

2.3.5 Substance Over-form

Transactions and other events and conditions should be accounted for and presented by their substance and not merely their legal form. This enhances the reliability of financial statements.

2.3.6 Prudence

The uncertainties that inevitably surround many events and circumstances are acknowledged by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated, and liabilities or expenses are not understated. However, the exercise of prudence does not allow the deliberate understatement of assets or income or the deliberate overstatement of liabilities or expenses. In short, prudence does not permit bias.

2.3.7 Completeness

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause the information to be false or misleading and thus unreliable and deficient in terms of its relevance.

2.3.8 Comparability

Users must be able to compare the financial statements of an entity over time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities to evaluate their relative financial position,

performance, and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events and conditions must be carried out consistently throughout an entity and over time for that entity and in a consistent way across entities. In addition, users must be informed of the accounting policies employed in the preparation of the financial statements and of any changes in those policies and the effects of such changes.

2.3.9 Timeliness

To be relevant, financial information must be able to influence the economic decisions of users. Timeliness involves providing the information within the decision time frame. If there is undue delay in the reporting of information, it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the needs of users in making economic decisions.

2.3.10 The balance between benefit and cost

- (i) The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is substantially a judgmental process. Furthermore, the costs are not necessarily borne by those who enjoy the benefits, and often the benefits of the information are enjoyed by a broad range of external users.
- (ii) Financial reporting information helps capital providers make better decisions, which results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. Individual entities also enjoy benefits, including improved access to capital markets, favourable effect on public relations and perhaps lower costs of capital. The benefits may also include better management decisions because financial information used internally is often based at least partly on information prepared for general-purpose financial reporting purposes.

2.3.11 Undue cost or effort

- a. An undue cost or effort exemption is specified for some requirements in this Standard. This exemption shall not be used for other requirements in this Standard.
- b. Considering whether obtaining or determining the information necessary to comply with a requirement would involve undue cost or effort depends on the entity's specific circumstances and on management's judgment of the costs and benefits from applying that requirement. This judgement requires consideration of how the economic decisions of those who are expected to use the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceeds the benefits that those who are expected to use the SME's financial statements would receive from having the information. An assessment of undue cost or effort by an SME in accordance with this Standard would usually constitute a lower hurdle than an assessment of undue cost or effort by a publicly accountable entity because SMEs are not accountable to public stakeholders.
- c. Assessing whether a requirement would involve undue cost or effort on initial

recognition in the financial statements, for example, at the date of the transaction, should be based on information about the costs and benefits of the requirement at the time of initial recognition. If the undue cost or effort exemption also applies after initial recognition, for example, to a subsequent measurement of an item, a new assessment of undue cost or effort should be made at that subsequent date, based on information available at that date.

- d. Except for the undue cost or effort exemption, which is covered by the disclosure requirements, whenever an undue cost or effort exemption is used by an entity, the entity shall disclose that fact and the reasons why applying the requirement would involve undue cost or effort.

2.4 Financial position

The financial position of an entity is the relationship of its assets, liabilities, and equity as of a specific date, as presented in the statement of financial position. These are defined as follows:

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

Some items that meet the definition of an asset or a liability may not be recognised as assets or liabilities in the statement of financial position because they do not satisfy the criteria for recognition. In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion before an asset or liability is recognised.

2.4.1 Assets

The future economic benefit of an asset is its potential to contribute, directly or indirectly, to the flow of **cash** and **cash equivalents** to the entity. Those cash flows may come from using the asset or from disposing of it.

- (i) Many assets, for example, **property, plant and equipment**, have a physical form. However, physical form is not essential to the existence of an asset. Some assets are intangible.
- (ii) In determining the existence of an asset, the right of ownership is not essential. Thus, for example, property held on a **lease** is an asset if the entity controls the benefits that are expected to flow from the property.

2.4.2 Liabilities

An essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way. The obligation may be either a legal obligation or a constructive obligation. A legal obligation is legally enforceable as a consequence of a

binding contract or statutory requirement. A constructive obligation is an obligation that derives from an entity's actions when:

- a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

The settlement of a present obligation usually involves the payment of cash, the transfer of other assets, the provision of services, the replacement of that obligation with another obligation, or the conversion of the obligation to equity. An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

2.4.3 Equity

Equity is the residual of recognised assets minus recognised liabilities. It may be subclassified in the statement of financial position. For example, in a corporate entity, subclassifications may include funds contributed by shareholders, retained earnings, and items of **other comprehensive income** recognised as a separate component of equity. This Standard does not prescribe how, when, or if amounts can be transferred between components of equity.

2.5 Performance

- i. Performance is the relationship between the income and expenses of an entity during a **reporting period**. This Standard permits entities to present performance in a single financial statement (a **statement of comprehensive income**) or two financial statements (an **income statement** and a statement of comprehensive income). **Comprehensive total income** and **profit or loss** are frequently used as measures of performance or as the basis for other measures, such as return on investment or earnings per share. Income and expenses are defined as follows:
 - a. income is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from **owners**; and
 - b. Expenses are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to owners.
- ii. The recognition of income and expenses results directly from the recognition and measurement of assets and liabilities.

2.5.1 Income

- i. The definition of income encompasses both **revenue** and **gains**: Revenue is income that arises in the course of the ordinary activities of an entity and is referred to by a variety of names, including sales, fees, interest, dividends, royalties, and rent.
- ii. Gains are other items that meet the definition of income but are not revenue. When gains are recognised in the statement of comprehensive income, they are usually

displayed separately because knowledge of them is useful for making economic decisions

2.5.2 Expenses

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity:

- a) Expenses that arise in the course of the ordinary activities of the entity include, for example, the cost of sales, wages, and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, or property, plant, and equipment.
- b) losses are other items that meet the definition of expenses and may arise during the ordinary activities of the entity. When losses are recognized in the statement of comprehensive income, they are usually presented separately because knowledge of them is useful for making economic decisions.

2.6 Recognition of Assets, Liabilities, Income, and Expenses

- i. Recognition is the process of incorporating in the financial statements an item that meets the definition of an asset, liability, income or expense and satisfies the following criteria:
 - a) It is probable that any future economic benefit associated with the item will flow to or from the entity; and
 - b) The item has a cost or value that can be measured reliably.
- ii. The failure to recognise an item that satisfies those criteria is not rectified by disclosure of the accounting policies used or by notes or explanatory material.

2.6.1 The probability of future economic benefit

The concept of probability is used in the first recognition criterion to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. Assessments of the degree of uncertainty attached to the flow of future economic benefits are made based on the evidence relating to conditions at the end of the reporting period available when the financial statements are prepared. Those assessments are made individually for individually significant items and in a group for a large population of individually insignificant items.

2.6.2 Reliability of measurement

- i. The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability. In many cases, the cost or value of an item is known. In other cases, it must be estimated. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When a reasonable estimate cannot be made, the item is not recognised in the financial statements.
- ii. An item that fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events.
- iii. An item that fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes or explanatory material or supplementary schedules.

2.7 Measurement of assets, liabilities, income, and expenses

Measurement is the process of determining the monetary amounts at which an entity measures assets, liabilities, income, and expenses in its financial statements. Measurement involves the selection of a basis of measurement. This Standard IFRS specifies which measurement basis an entity shall use for many types of assets, liabilities, income, and expenses.

Two common measurement bases are historical cost and fair value:

- i. For assets, historical cost is the amount of cash or cash equivalents paid, or the fair value of the consideration given to acquire the asset at the time of its acquisition. For liabilities, historical cost is the amount of proceeds of cash or cash equivalents received, or the fair value of non-cash assets received in exchange for the obligation at the time the obligation is incurred, or in some circumstances (for example, income tax) the amounts of cash or cash equivalents expected to be paid to settle the liability in the normal course of business. Amortised historical cost is the historical cost of an asset or liability plus or minus that portion of its historical cost previously recognised as expense or income.
- ii. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. In situations in which fair value measurement is permitted or required.

2.8 Pervasive recognition and measurement principles

The requirements for recognising and measuring assets, liabilities, income, and expenses in this Standard are based on pervasive principles that are derived from full IFRS. In the absence of a requirement in this Standard that applies specifically to a transaction or other event, or a condition that guides making a judgment and establishes a hierarchy for an entity to follow in deciding on the appropriate accounting policy in the circumstances. The second level of that hierarchy requires an entity to look at the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses, and the pervasive principles set out in this section.

2.9 Accrual basis

An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. On an accrual basis, items are recognised as assets, liabilities, equity, income, or expenses when they satisfy the definitions and recognition criteria for those items.

2.10 Recognition in Financial Statements

2.10.1 Assets

- a) An entity shall recognise an asset in the statement of financial position when it is probable that future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. An asset is not recognised in the statement of financial position when the expenditure has been incurred for which it is considered not probable that economic benefits will flow to the entity beyond the current reporting period. Instead, such a transaction results in the recognition of an expense in the statement of comprehensive income (or in the income statement, if

presented).

- b) An entity shall not recognise a **contingent asset** as an asset. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.

2.10.2 Liabilities

- a. An entity shall recognise a liability in the statement of financial position when:
 - i. The entity has an obligation at the end of the reporting period as a result of a past event;
 - ii. It is probable that the entity will be required to transfer resources embodying economic benefits in settlement; and
 - iii. The settlement amount can be measured reliably.

b. A **contingent liability** is either a possible but uncertain obligation or a present obligation that is not recognised because it fails to meet one or both of the conditions (b) and (c) in paragraph 2.39. An entity shall not recognise a contingent liability as a liability, except for contingent liabilities of an acquiree in a **business combination** (see Section 19 Business Combinations and Goodwill).

i. Income

The recognition of income results directly from the recognition and measurement of assets and liabilities. An entity shall recognise income in the statement of comprehensive income (or in the income statement, if presented) when an increase in future economic benefits related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably.

2.10.3 Expenses

The recognition of expenses results directly from the recognition and measurement of assets and liabilities. An entity shall recognise expenses in the statement of comprehensive income (or in the income statement, if presented) when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability has arisen that can be measured reliably.

2.10.4 Total comprehensive income and profit or loss

- a) Total comprehensive income is the arithmetic difference between income and expenses. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.
- b) Profit or loss is the arithmetical difference between income and expenses other than those items of income and expense that this Standard classifies as items of other comprehensive income. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.
- c) This Standard does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities, regardless of whether they result from applying the notion commonly referred to as the 'matching concept' for measuring profit or loss.

2.11 Measurement at Initial Recognition

At initial recognition, an entity shall measure assets and liabilities at historical cost unless this Standard requires initial measurement on another basis, such as fair value.

2.12 Subsequent measurement

2.12.1 Financial assets and financial liabilities

- i. An entity measures basic **financial assets** and basic **financial liabilities**, as defined in Section 11 *Basic Financial Instruments*, at amortized cost less **impairment** except for investments in non-convertible preference shares and non-puttable ordinary or preference shares that are **publicly traded** or whose fair value can otherwise be measured reliably without undue cost or effort, which are measured at fair value with changes in fair value recognized in profit or loss.
- ii. An entity generally measures all other financial assets and financial liabilities at fair value, with changes in fair value recognised in profit or loss, unless this Standard requires or permits measurement on another basis, such as cost or amortised cost.

2.12.2 Non-financial assets

Most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases. For example:

- (a) An entity measures property, plant, and equipment either at the lower of cost less any accumulated depreciation and impairment and the **recoverable amount** (cost model) or the lower of the revalued amount and the recoverable amount (revaluation model);
- (b) An entity measures inventories at the lower of cost and selling price less costs to complete and sell; and
- (c) An entity recognises an impairment loss relating to non-financial assets that are in use or held for sale.

Measurement of assets at those lower amounts is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.

For the following types of non-financial assets, these Standard permits or requires measurement at fair value:

- (d) Investments in associates and joint ventures that an entity measures at fair value
- (e) investment property that an entity measures at fair value.
- (f) Agricultural assets (biological assets and agricultural produce at the point of harvest) that an entity measures at fair value less estimated costs to sell.
- (g) Property, plant, and equipment that an entity measures by the revaluation model.

2.12.3 Liabilities other than financial liabilities

Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.

2.13 Offsetting

An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by this Standard:

- (a) Measuring assets net of valuation allowances is not offsetting. For example, allowances for inventory obsolescence and allowances for uncollectible receivables.
- (b) If an entity's normal operating activities do not include buying and selling non-current assets, including investments and operating assets, then the entity reports gains and losses on disposal of such assets by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses.

Summary

This unit explores fundamental financial concepts and principles relevant to small and medium-sized entities (SMEs). It outlines the objectives of financial statements, emphasising their role in decision-making. Key qualitative characteristics such as relevance, reliability, and comparability are discussed. The unit also covers financial position and performance measurement, including asset and liability recognition. Measurement principles, including historical cost and fair value, are analysed. The accrual basis of accounting is explained alongside recognition criteria. It highlights the significance of prudence and completeness in reporting. Financial reporting helps investors, lenders, and other stakeholders make informed decisions. The unit further discusses subsequent measurement and impairment recognition. Offsetting rules and considerations are also covered for better financial transparency.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015

Unit -3

FINANCIAL STATEMENT ANALYSIS

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INTRODUCTION

Financial Statement Analysis is a key tool for assessing a company's performance and financial health. It involves examining financial statements to evaluate profitability, liquidity, solvency, and efficiency. Businesses, investors, and creditors rely on these analyses for decision-making. The process includes ratio analysis, trend analysis, and comparative analysis. IFRS for SMEs provides a structured approach to financial reporting. A fair presentation of statements ensures transparency. This section explains how financial data can be used for better decision-making.

OBJECTIVES

After reading this unit, you will be able to understand the following concepts.

1. To understand the importance of financial statement analysis in decision-making.
2. To learn key financial ratios and their interpretations.
3. To examine the structure and presentation of financial statements.
4. To apply IFRS for SMEs in financial reporting.
5. To enhance financial literacy for business assessment.

3.1 Financial Statement Presentation

This section explains the **fair presentation** of **financial statements**, what compliance with the IFRS for SMEs requires, and what a complete set of financial statements is.

3.1.1 Fair presentation

- i. Financial statements shall present fairly the **financial position**, **financial performance**, and **cash flows** of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions by the definitions and **recognition** criteria for **assets**, **liabilities**, **income**, and **expenses** set out in Chapter -2, Concepts and Pervasive Principles:
 - (a) The application of the IFRS for SMEs, with additional disclosure, when necessary, is presumed to result in financial statements that achieve a fair presentation of the financial position, financial performance, and cash flows of SMEs.
 - (b) As explained in paragraph 1.5, the application of this Standard by an entity with **public accountability** does not result in a fair presentation by this Standard.

The additional disclosures referred to in (a) are necessary when compliance with the specific requirements in this Standard is insufficient to enable users to understand the effect of particular transactions, other events, and conditions on the entity's financial position and financial performance.

3.1.2 Compliance with the IFRS for SMEs

- ii. An entity whose financial statements comply with the IFRS for SMEs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with the **IFRS for SMEs** unless they comply with all the requirements of this Standard.
- iii. In the extremely rare circumstances when management concludes that compliance with this Standard would be so misleading that it would conflict with the objective of the financial statements of SMEs. The entity shall depart from that requirement in the manner set out in paragraph
- iv. Unless the relevant regulatory framework prohibits such a departure.
 - v. When an entity departs from a requirement of this Standard, it shall disclose the following:
 - (a) That management has concluded that the financial statements present
 - (b) fairly the entity's financial position, financial performance, and cash flow: that it has complied with the **IFRS for SMEs**, except that it has departed from a particular requirement to achieve a fair presentation; and the nature of the departure, including the treatment that the IFRS for SMEs would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in Section 2 and the treatment adopted.
- iii. When an entity has departed from a requirement of this Standard in a prior period, and that departure affects the amounts recognised in the financial statements for the current period,
- iv. In the extremely rare circumstances when management concludes that compliance with

a requirement in this Standard would be so misleading that it would conflict with the objective of financial statements of SMEs set out in Section 2, but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing the following:

- (a) the nature of the requirement in this Standard and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in Section 2; and
- (b) For each period presented, adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

3.1.3 Statement of Financial Position

Scope of this section: This section sets out the information that is to be presented in a statement of financial position and how to present it. The statement of financial position (sometimes called the balance sheet) presents an entity's assets, liabilities, and equity as of a specific date—the end of the reporting period.

3.1.4 Information to be presented in the Statement of Financial Position

i. Information to be presented in the statement of financial position as a minimum, the statement of financial position shall include line items that present the following amounts:

- (a) cash and cash equivalents.
- (b) trade and other receivables.
- (c) **financial assets** (excluding amounts shown under (a), (b), (j), and (k)).
inventories.
- (d) **Property, plant, and equipment.**
- (e) **investment property** carried at cost less accumulated **depreciation** and **impairment.**
- (f) investment property carried at **fair value** through **profit or loss.**
- (g) Intangible assets.
- (h) **biological assets** carried at cost less accumulated depreciation and impairment.
- (i) biological assets carried at fair value through profit or loss; investments in **associates;**
- (j) Investments in **jointly controlled entities;**
- (k) trade and other payables;
- (l) **financial liabilities** (excluding amounts shown under (l) and (p));
- (m) Liabilities and assets for **current tax;**
- (n) **deferred tax liabilities** and **deferred tax assets** (these shall always be classified as non-current);
- (o) provisions;
- (p) **non-controlling interest**, presented within equity separately from the equity attributable to the **owners** of the **parent;** and
- (q) Equity attributable to the owners of the parent.

- i. An entity shall present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.

3.1.5 Current/non-current distinction

An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position, except when a presentation based on liquidity provides information that is reliable and more relevant. When that exception applies, all assets and liabilities shall be presented in order of approximate liquidity (ascending or descending).

3.1.6 Current assets

An entity shall classify an asset as current when:

- (a) It expects to realise the asset or intends to sell or consume it, in the entity's normal operating cycle.
- (b) It holds the asset primarily for trading.
- (c) It expects to realise the asset within twelve months after the reporting date, or
- (d) the asset is cash or a cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

An entity shall classify all other assets as non-current. When the entity's normal operating cycle is not identifiable, its duration is assumed to be twelve months.

3.1.7 Current liabilities

An entity shall classify a liability as current when:

- (a) It expects to settle the liability in the entity's normal operating cycle;
- (b) It holds the liability primarily for trading.
- (c) The liability is due to be settled within twelve months after the reporting date; or
- (d) The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date.

An entity shall classify all other liabilities as non-current.

3.1.8 Sequencing of items and format of items in the statement of financial position

This Standard does not prescribe the sequence or format in which items are to be presented. Paragraph 4.2 simply provides a list of items that are sufficiently different in nature or function to warrant separate presentation in the statement of financial position. In addition:

- (a) Line items are included when the size, nature, or function of an item or aggregation of similar items is such that a separate presentation is relevant to an understanding of the entity's financial position; and
- (b) The descriptions used and the sequencing of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position.

The judgment on whether additional items are presented separately is based on an assessment of all the following:

- (a) the amounts, nature, and liquidity of assets;
- (b) The function of assets within the entity; and
- (c) the amounts, nature, and timing of liabilities.

3.1.9 Information to be Presented Either in the Statement of Financial Position or in the Notes: An entity shall disclose, either in the statement of financial position or in the notes, the following subclassifications of the line items presented:

- (a) Property, plant, and equipment in classifications appropriate to the entity;
- (b) trade and other receivables showing separately amounts due from related parties, amounts due from other parties, and receivables arising from accrued **income** not yet billed;
- (c) inventories, showing separate amounts of inventories:
 - (i) held for sale in the ordinary course of business;
 - (ii) in the process of production for such sale; and
 - (iii) in the form of materials or supplies to be consumed in the production process or the rendering of services.
- (d) trade and other payables, showing separately amounts payable to trade suppliers, payable to related parties, deferred income, and accruals;
- (e) provisions for **employee benefits** and other provisions; and
- (f) classes of equity, such as paid-in capital, share premium, retained earnings, and items of income and **expense** that, as required by this Standard, are recognised in **other comprehensive income** and presented separately in equity.

An entity with share capital shall disclose the following, either in the statement of financial position or in the notes:

- (g) For each class of share capital:
 - (i) the number of shares authorised.

The number of shares issued and fully paid, and issued but not fully paid.

3.2 Statement of Comprehensive Income and Income Statement

3.2.1 Scope of this section

This section requires an entity to present its total comprehensive income for a period—ie, its financial performance for the period—in one or two financial statements. It sets out the information that is to be presented in those statements and how to present it.

3.2.2 Presentation of total comprehensive income

- i. An entity shall present its total comprehensive income for a period of either:
 - a. in a single statement of comprehensive income, in which case the statement of comprehensive income presents all items of income and expense recognised in the period; or

- b. In two statements—an income statement and a statement of comprehensive income—the income statement presents all items of income and expense recognised in the period except those recognised in total comprehensive income outside of profit or loss as permitted or required by this Standard.
- ii. A change from the single-statement approach to the two-statement approach, or vice versa, is a change in accounting policy to which Section 10 applies, *Accounting Policies, Estimates, and Errors* applies.

3.2.2.1 Single-statement approach

- i. Under the single-statement approach, the statement of comprehensive income shall include all items of income and expenses recognised in a period unless this Standard requires otherwise. This Standard provides different treatment for the following circumstances:
 - a. The effects of corrections of **errors** and changes in **accounting policies** are presented as retrospective adjustments of prior periods instead of as part of profit or loss in the period in which they arise (see Section 10); and
 - b. Four types of **other comprehensive income** are recognised as part of total comprehensive income, outside of profit or loss, when they arise:
 - ii. some **gains** and **losses** arising on translating the financial statements of a **foreign operation** (see Section 30 *Foreign Currency Translation*);
 - a. some actuarial gains and losses (see Section -*Employee Benefits*);
 - b. some changes in **fair values** of **hedging instruments** (see Section - *Other Financial Instrument Issues*); and
 - c. Changes in the revaluation surplus for **property, plant, and equipment** measured by the revaluation model (see Section - Property, Plant, and Equipment).
 - d. As a minimum, an entity shall include, in the statement of comprehensive income, line items that present the following amounts for the period:
 - i. Revenue.
 - ii. finance costs.
 - iii. share of the profit or loss of investments in **associates** (see Section 14 Investments in Associates) and **jointly controlled entities** (see Section 15 Investments in Joint Ventures), accounted for using the equity method.
 - iv. **tax expense** excluding tax allocated to items (e), (g) and (h) (see paragraph 29.35).
 - v. a single amount comprising the total of:
 - 1. the post-tax profit or loss of a **discontinued operation**; and
 - 2. the post-tax gain or loss attributable to an **impairment**, or reversal of an impairment, of the **assets** in the discontinued operation (see Section 27 *Impairment of Assets*), both at the time and after being classified as a discontinued operation and to the disposal of the net assets constituting the discontinued operation.
 - vi. profit or loss (if an entity has no items of other comprehensive income, this line need not be presented).

- vii. Each item of other comprehensive income (see paragraph 5.4(b)) classified by nature (excluding amounts in (h)). Such items shall be grouped into those that, follow this Standard:
 - 1. will not be reclassified subsequently to profit or loss—ie those in paragraph 5.4(b)(i)–(ii) and (iv); and
 - 2. will be reclassified subsequently to profit or loss when specific conditions are met those in paragraph 5.4(b)(iii).
- viii. share of the other comprehensive income of associates and jointly controlled entities accounted for by the equity method.
- ix. total comprehensive income (if an entity has no items of other comprehensive income, it may use another term for this line, such as profit or loss).
- e. An entity shall disclose separately the following items in the statement of comprehensive income as allocations for the period: profit or loss for the period attributable to
 - 1. non-controlling interest; and
 - 2. owners of the parent
- ii. Total comprehensive income for the period attributable to
 - 1. non-controlling interest; and
 - 2. owners of the parent.

3.2.2.2 Two-statement approach

Under the two-statement approach, the income statement shall display, as a minimum, line items that present the amounts in paragraphs 5.5(a)–5.5(f) for the period, with profit or loss as the last line. The statement of comprehensive income shall begin with profit or loss as its first line and shall display, as a minimum, line items that present the amounts in paragraphs 5.5(g)–5.5(i) and paragraph 5.6 for the period.

3.2.2.3 Requirements applicable to both approaches

- i. Under this Standard, the effects of corrections of errors and changes in accounting policies are presented as retrospective adjustments of prior periods instead of as part of profit or loss in the period in which they arise (see Section 10).
- ii. An entity shall present additional line items, headings, and subtotals in the statement of comprehensive income (and in the income statement, if presented) when such presentation is relevant to an understanding of the entity's financial performance.
- iii. An entity shall not present or describe any items of income and expense as 'extraordinary items' in the statement of comprehensive income (or in the income statement, if presented) or in the notes.

3.2.3 Analysis of Expenses

An entity shall present an analysis of expenses using a classification based on either the

nature of expenses or the function of expenses within the entity, whichever provides information that is reliable and more relevant.

Analysis of the nature of the expense

a) Under this method of classification, expenses are aggregated in the statement of comprehensive income according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits, and advertising costs) and are not reallocated among various functions within the entity.

Analysis by function of expense

b) Under this method of classification, expenses are aggregated according to their function as part of the cost of sales or, for example, the costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses.

3.3 Statement of Changes in Equity and Statement of Income and Expenses Earnings

3.3.1 Scope of this section

This section sets out requirements for presenting the changes in an entity's equity for a period, either in a statement of changes in equity or, if specified conditions are met and an entity chooses, in a statement of income and retained earnings.

3.3.2 Statement of changes in equity

Purpose: The statement of changes in equity presents an entity's profit or loss for a reporting period, other comprehensive income for the period, the effects of changes in accounting policies and corrections of errors recognized in the period, and the amounts of investments by, and dividends and other distributions to, owners in their capacity as owners during the period.

Information to be presented in the statement of changes in equity

The statement of changes in equity includes the following information:

- a. **total comprehensive income** for the period, showing separately the total amounts attributable to owners of parent and **non-controlling interests**;
- b. for each component of equity, the effects of **retrospective application** or retrospective restatement recognized by Section 10 *Accounting Policies, Estimates, and Errors*; and
- c. for each component of equity, a reconciliation between the **carrying amount** at the beginning and the end of the period, separately disclosing changes resulting from:
 - (i) profit or loss;

- (ii) other comprehensive income; and
- (iii) the amounts of investments by, and dividends and other distributions too, owners in their capacity as owners, showing separately issues of shares, **treasury share** transactions, dividends and other distributions to owners, and changes in ownership interests in **subsidiaries** that do not result in a loss of **control**.

3.3.3 Statement of income and retained earnings

- **Purpose:** The statement of income and retained earnings presents an entity's profit or loss and changes in retained earnings for a reporting period. Permits an entity to present a statement of income and retained earnings in place of a statement of comprehensive income and a statement of changes in equity if the only changes to its equity during the periods for which financial statements are presented arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy.
- **Information to be presented in the statement of income and retained earnings**

An entity shall present, in the statement of income and retained earnings, the following items in addition to the information required by Section 5 Statement of Comprehensive Income and Income Statement:

- i. Retained earnings at the beginning of the reporting period.
- ii. dividends declared and paid or payable during the period.
- iii. restatements of retained earnings for corrections of prior period errors.
- iv. Restatements of retained earnings for changes in accounting policy; and
- v. Retained earnings at the end of the reporting period.

3.4 Statement of Cash Flows

3.4.1 Scope of this section

This section sets out the information that is to be presented in a statement of cash flows and how to present it. The statement of cash flows provides information about the changes in cash and cash equivalents of an entity for a reporting period, showing separate changes from operating activities, investing activities, and financing activities.

3.4.2 Cash equivalents

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. They are held to meet short-term cash commitments instead of being invested or for other purposes. Consequently, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Bank overdrafts are normally considered financing activities similar to borrowings. However, if they are repayable on demand and form an integral part of an entity's cash management, bank overdrafts are a component of cash and cash equivalents.

3.4.3 Information to be presented in the statement of cash flows

An entity shall present a statement of cash flows that presents cash flows for a reporting period classified by operating activities, investing activities, and financing activities.

3.4.3.1 Operating activities

Operating activities are the principal revenue-producing activities of the entity. Consequently, cash flows from operating activities generally result from the transactions and other events and conditions that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

- (a) cash receipts from the sale of goods and the rendering of services.
- (b) cash receipts from royalties, fees, commissions, and other revenue.
- (c) cash payments to suppliers for goods and services.
- (d) cash payments to and on behalf of employees.
- (e) cash payments or refunds of income tax, unless they can be specifically identified with financing and investing activities; and cash receipts and payments from investments, loans and other contracts held for dealing or trading purposes, which are similar to inventory acquired specifically for resale.

Some transactions, such as the sale of a plant item by a manufacturing entity, may give rise to a gain or loss that is included in profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

3.4.3.2 Investing activities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Examples of cash flows arising from investing activities are:

- (a) cash payments to acquire **property, plant, and equipment** (including self-constructed property, plant, and equipment), **intangible assets**, and other long-term assets.
- (b) cash receipts from sales of property, plant, and equipment, intangibles, and other long-term assets.
- (c) cash payments to acquire **equity** or debt instruments of other entities and interests in **joint ventures** (other than payments for those instruments classified as cash equivalents or held for dealing or trading).
- (d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments classified as cash equivalents or held for dealing or trading).
- (e) cash advances and loans made to other parties.
- (f) cash receipts from the repayment of advances and loans made to other parties.
- (g) cash payments for futures contracts, forward contracts, option contracts, and swap contracts, except when the contracts are held for dealing or trading, or the payments

are classified as financing activities; and

- (h) cash receipts from futures contracts, forward contracts, option contracts, and swap contracts, except when the contracts are held for dealing or trading, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge, an entity shall classify the cash flow of the contract in the same manner as the cash flows of the item being hedged.

3.4.3.3 Financing activities

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of an entity. Examples of cash flows arising from financing activities are:

- (i) Cash proceeds from issuing shares or other equity instruments.
- (ii) cash payments to **owners** to acquire or redeem the entity's shares. Cash proceeds from issuing debentures, loans, notes, bonds, mortgages, and other short-term or long-term borrowings.
- (iii) cash repayments of amounts borrowed; and
- (iv) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

3.4.4 Reporting cash flows from operating activities: An entity shall present cash flows from operating activities using either:

- a) the indirect method, whereby profit or loss is adjusted for the effects of non-cash transactions, any deferrals or accruals of past or future operating cash receipts or payments and items of income or expenses associated with investing or financing cash flows; or
- b) The direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed.

Indirect method

Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

- (a) changes during the period in inventories, operating receivables, and payables.
- (b) non-cash items such as **depreciation, provisions, deferred tax**, accrued income (expenses) not yet received (paid) in cash, unrealized foreign currency gains and losses, undistributed profits of **associates** and **non-controlling interests**; and
- (c) all other items for which the cash effects relate to investing or financing.

Direct method

Under the direct method, net cash flow from operating activities is presented by disclosing information about major classes of gross cash receipts and gross cash payments. Such information may be obtained either:

- (a) from the accounting records of the entity; or

- (b) by adjusting sales, cost of sales and other items in the **statement of comprehensive income** (or the **income statement**, if presented) for: changes during the period in inventories and operating receivables and payables.
- (i) other non-cash items; and
- (ii) other items for which the cash effects are investing or financing cash flows.

3.4.5 Reporting cash flows from investing and financing activities:

An entity shall present separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities. The aggregate cash flows arising from acquisitions and disposals of **subsidiaries** or other business units shall be presented separately and classified as investing activities.

3.4.6 Foreign currency cash flows

- (i) An entity shall record cash flows arising from transactions in a foreign currency in the entity's **functional currency** by applying to the foreign currency the exchange rate between the functional currency and the foreign currency at the date of the cash flow. Paragraph 30.19 explains when an exchange rate that approximates the actual rate can be used.
- (ii) The entity shall translate the cash flows of a foreign subsidiary at the exchange rates between the entity's functional currency and the foreign currency at the dates of the cash flows.
- (iii) Unrealized gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, to reconcile cash and cash equivalents at the beginning and the end of the period, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency must be presented in the statement of cash flows. Consequently, the entity shall remeasure cash and cash equivalents held during the reporting period (such as amounts of foreign currency held and foreign currency bank accounts) at period-end exchange rates. The entity shall present the resulting unrealized gain or loss separately from cash flows from operating, investing, and financing activities.

3.4.7 Interest and Dividends

- a. An entity shall present separate cash flows from interest and dividends received and paid. The entity shall classify cash flow consistently from period to period as operating, investing, or financing activities.
- b. An entity may classify interest paid and interest and dividends received as operating cash flows because they are included in profit or loss. Alternatively, the entity may classify interest paid and interest and dividends received as financing cash flows and investing cash flows, respectively, because they are costs of obtaining financial resources or returns on investments.
- c. An entity may classify dividends paid as a financing cash flow because they are a cost of obtaining financial resources. Alternatively, the entity may classify dividends paid as a component of cash flows from operating activities because they are paid out of operating cash flows.
- d. **Income tax:** An entity shall present separate cash flows arising from income tax

and shall classify them as cash flows from operating activities unless they can be specifically identified with financing and investing activities. When tax cash flows are allocated over more than one class of activity, the entity shall disclose the total amount of taxes paid.

3.4.8 Non-cash transactions:

An entity shall exclude from the statement of cash flows investing and financing transactions that do not require the use of cash or cash equivalents. An entity shall disclose such transactions elsewhere in financial statements in a way that provides all the relevant information about those investing and financing activities.

Many investing and financing activities do not have a direct impact on current cash flows, even though they affect the capital and asset structure of an entity. The exclusion of non-cash transactions from the statement of cash flows is consistent with the objective of a statement of cash flows because these items do not involve cash flows in the current period. Examples of non-cash transactions are:

- (a) The acquisition of assets either by assuming directly related liabilities or using a finance lease.
- (b) the acquisition of an entity using an equity issue; and
- (c) The conversion of debt to equity.

3.4.9 Components of cash and cash equivalents

An entity shall present the components of cash and cash equivalents and shall present a reconciliation of the amounts presented in the statement of cash flows to the equivalent items presented in the statement of financial position. However, an entity is not required to present this reconciliation if the amount of cash and cash equivalents presented in the statement of cash flows is identical to the amount similarly described in the statement of financial position.

3.4.10 Other disclosures

An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the entity. Cash and cash equivalents held by an entity may not be available for use by the entity because of, among other reasons, foreign exchange controls or legal restrictions.

For example, A company may have significant cash and cash equivalents that are not available for use due to foreign exchange controls imposed by the State Bank of Pakistan (SBP). For example, exporters' foreign currency earnings may be subject to repatriation requirements or capital account restrictions, limiting their free usage. Additionally, funds held in escrow accounts for regulatory compliance or restricted bank accounts for specific government projects may also be unavailable for general business operations.

3.5 Notes to the Financial Statements

3.5.1 Scope of this section:

This section sets out the principles underlying information that is to be presented in the notes to the financial statements and how to present it. Notes contain information in addition to that presented in the statement of financial position, the statement of comprehensive income (if presented), the income statement (if presented), the combined statement of income and retained earnings (if presented), the statement of changes in equity (if presented) and the statement of cash flows. Notes provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements. In addition to the requirements of this section, nearly every other section of this Standard requires disclosures that are normally presented in the notes.

3.5.2 Structure of the Notes:

- 1.** The notes shall.
 - (i) presents information about the basis of the preparation of the financial statements and the specific accounting policies used.
 - (ii) disclose the information required by this Standard that is not presented elsewhere in the financial statements; and
 - (iii) provide information that is not presented elsewhere in the financial statements but is relevant to an understanding of any of them.
- 2.** An entity shall, as far as practicable, systematically present the notes. An entity shall cross-reference each item in the financial statements to any related information in the notes.
- 3.** An entity normally presents the notes in the following order:
 - (a) a statement that the financial statements have been prepared in compliance with the IFRS for SMEs.
 - (b) A summary of significant accounting policies applied.
 - (c) supporting information for items presented in the financial statements, in the sequence in which each statement and each line item is presented; and
 - (d) any other disclosures.

3.5.3 Disclosure of Accounting Policies:

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

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

3.5.5 Information about judgments:

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

3.5.6 Information about key sources of estimation uncertainty:

An entity shall disclose in the notes information about the key assumptions concerning the future and other key sources of estimation uncertainty at the reporting 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 at the end of the **reporting period**.

Summary

Financial statement analysis helps stakeholders assess a company's performance. It includes ratio analysis, cash flow assessment, and trend examination. The statement of financial position highlights assets, liabilities, and equity. The income statement presents revenue and expenses, while the cash flow statement tracks liquidity. IFRS for SMEs ensures uniform financial reporting standards. Businesses use these analyses for investment, credit, and management decisions. Fair presentation and compliance with IFRS enhance financial transparency. Effective analysis improves strategic planning. Understanding financial statements is crucial for sustainability.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015

Unit - 4

INVENTORIES

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INTRODUCTION

Inventories are a crucial part of an entity's financial reporting, especially for manufacturing, retail, and service-based SMEs. This unit outlines how inventories are recognized, measured, and recorded in financial statements. It explains the cost components, including purchase, conversion, and overheads, necessary to bring inventories to their current condition. Various costing techniques, such as FIFO, weighted average, and specific identification, are discussed. Special attention is given to joint and by-product cost allocation, ensuring fair cost distribution. The unit also covers impairment assessment to prevent overstatement of inventory values. Inventory write-offs and recognition as expenses are explained to align financial reporting standards. SMEs in Pakistan use standard costing techniques to ensure transparency. This unit also highlights inventory disclosures and compliance with IFRS for SMEs.

OBJECTIVES

- Understand inventory measurement principles and their importance in financial reporting.
- Learn various costing techniques such as FIFO, weighted average, and specific identification.
- Identify joint products and by-products and apply cost allocation methods.
- Analyse inventory impairment and how to recognize inventory as an expense.
- Apply costing techniques in SMEs, ensuring compliance with IFRS for SMEs.
- Gain insight into inventory disclosures for accurate financial representation.

INVENTORIES

4.1 Scope of this section

- i. This section sets out the principles for recognizing and measuring **inventories**. Inventories are **assets**:
 - a. held for sale in the ordinary course of business.
 - b. in the process of production for such sale; or
 - c. in the form of materials or supplies to be consumed in the production process or the rendering of services.
- ii. This section applies to all inventories, except:
 - a. work in progress arising under **construction contracts**, including directly related service contracts (Section, *Revenue*).
 - b. **Financial, Financial Instruments** (Financial Instruments and Other Financial Instrument Issues)
 - c. **biological assets** related to **agricultural activity** and **agricultural produce** at the point of harvest (see Section Specialized Activities).
- iii. This section does not apply to the **measurement** of inventories held by:
 - a. producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at **fair value less costs to sell** through **profit or loss**; or
 - b. commodity brokers and dealers that measure their inventories at fair value less costs to sell through profit or loss

4.2 Measurement of inventories

An entity shall measure inventories at the lower cost and estimated selling price less costs to complete and sell.

Example of a Pakistani SME Applying Inventory Valuation

Example: Chase Up (Retail & FMCG SME)

Chase Up, a well-known retail SME in Pakistan, follows the lower of cost and net realizable value (NRV) principle for inventory valuation. Suppose the company purchases 500 units of packaged rice at PKR 200 per unit, making the total cost PKR 100,000. Due to market fluctuations, the selling price drops to PKR 190 per unit, and the estimated selling costs (such as packaging and transportation) are PKR 5 per unit.

To comply with IFRS for SMEs, Chase Up calculates the NRV as follows:
NRV = Selling Price - Costs to Sell

NRV = PKR 190 - PKR 5 = PKR 185 per unit

Since PKR 185 (NRV) is lower than PKR 200 (cost per unit), the company records inventory at PKR 185 per unit, reducing the total inventory value to PKR 92,500. This ensures that inventory is not overstated, and financial reports reflect the true recoverable value.

4.3 Cost of inventories

An entity shall include in the cost of inventories all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.

4.4 Costs of Purchase

- i. The costs of purchase of inventories comprise the purchase price, import duties, and other taxes (other than those subsequently recoverable by the entity from the taxing authorities) and transport, handling, and other costs directly attributable to the acquisition of finished goods, materials, and services. Trade discounts, rebates, and other similar items are deducted in determining the costs of purchase.
- ii. An entity may purchase inventories on deferred settlement terms. In some cases, the arrangement effectively contains an unstated financing element, for example, a difference between the purchase price for normal credit terms and the deferred settlement amount. In these cases, the difference is recognised as interest expense throughout the financing and is not added to the cost of the inventory.

4.5 Costs of Conversion

- a) The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

4.6 Allocation of production overheads

1. An entity shall allocate fixed production overheads to the costs of conversion based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over several periods or seasons under normal circumstances, considering the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased because of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production based on the actual use of the production facilities.

4.7 Joint products and by-products

1. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of raw materials or conversion of each product are not separately identifiable, an entity shall allocate them between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in

the production process when the products become separately identifiable or after production. Most by-products, by their nature, are immaterial. When this is the case, the entity shall measure them at the selling price less costs to complete and sell and deduct this amount from the cost of the main product. As a result, the **carrying amount** of the main product is not **materially** different from its cost.

Example of Joint Products & By-Products in a Pakistani SME

Case Study: Punjab Oil Mills (Edible Oil & Ghee Industry)

Punjab Oil Mills, a well-known **SME in Pakistan**, produces **edible oil and ghee** from oilseeds such as **soybean, sunflower, and canola**. During this process, a **by-product called oil cakes** (residual solids from the oil extraction process) is also produced, which is sold separately for use in animal feed.

Punjab Oil Mills, a well-known **SME in Pakistan**, produces **edible oil and ghee** from oilseeds such as **soybean, sunflower, and canola**. During this process, a **by-product called oil cakes** (residual solids from the oil extraction process) is also produced, which is sold separately for use in animal feed.

1. Production Process & Cost Allocation

Step 1: Input (Raw Material): Punjab Oil Mills processes 100,000 kg of oilseeds into two main products (edible oil & ghee) and one by-product (oil cakes).

Step 2: Output (Finished Goods & By-Products)

After processing, the output is:

- Edible Oil: 40,000 kg
- Ghee: 50,000 kg
- By-Product (Oil Cakes): 10,000 kg

The total production cost incurred (including raw material, labour, and overheads) is PKR 10,000,000.

2. Cost Allocation Using the Relative Sales Value Method: Since the direct costs for each product are not separately identifiable, Punjab Oil Mills allocates costs based on the relative sales value of each product.

Step 1: Determine Market Prices; The market price of each product is as follows:

- Edible Oil: PKR 500 per kg
- Ghee: PKR 400 per kg
- By-Product (Oil Cakes): PKR 50 per kg

Step 2: Calculate the Total Revenue of Each Product

- Edible Oil Revenue: 40,000 kg × PKR 500 = PKR 20,000,000
- Ghee Revenue: 50,000 kg × PKR 400 = PKR 20,000,000
- By-Product (Oil Cakes) Revenue: 10,000 kg × PKR 50 = PKR 500,000

Step 3: Calculate Cost Allocation Ratio for Main Products: Since the by-product's selling price is deducted from the total production cost, we allocate costs to edible oil and ghee based on their proportion of total revenue:

- Total Revenue (Excluding By-Product):

$$\text{PKR } 20,000,000 + \text{PKR } 20,000,000 = \text{PKR } 40,000,000$$

- Cost Allocation Ratio:
 - Edible Oil: $20,000,000 \div 40,000,000 = 50\%$
 - Ghee: $20,000,000 \div 40,000,000 = 50\%$

3. Final Cost Allocation: Since the total production cost is PKR 10,000,000, and the by-product (oil cakes) is sold at PKR 500,000, we adjust the main product costs accordingly:

Step 1: Deduct By-Product Revenue from Total Cost

- Adjusted Production Cost = PKR 10,000,000 - PKR 500,000 = PKR 9,500,000

Step 2: Allocate Costs to Main Products

- Edible Oil Cost = $50\% \times \text{PKR } 9,500,000 = \text{PKR } 4,750,000$
- Ghee Cost = $50\% \times \text{PKR } 9,500,000 = \text{PKR } 4,750,000$

Thus, the carrying amount of Edible Oil & Ghee is properly allocated, ensuring compliance with IFRS for SMEs.

4.7 Financial Impact & Decision-Making

- The by-product's revenue reduces the cost of the main products, making them more profitable.
- The company can price its edible oil and ghee competitively while ensuring sustainable cost management.
- Following IFRS guidelines, Punjab Oil Mills does not allocate direct costs to the by-product, as it is considered immaterial.

4.8 Other costs included in inventories

- An entity shall include other costs in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. In some circumstances, the change in the fair value of the hedging instrument in a hedge of fixed interest rate risk or commodity price risk of a commodity held adjusts the carrying amount of the commodity.

4.9 Costs excluded from inventories

- Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:
 - abnormal amounts of wasted materials, labor or other production costs;
 - storage costs, unless those costs are necessary during the production process before a further production stage.
 - Administrative overheads that do not contribute to bringing inventories to their present location and condition; and
 - selling costs.

4.10 Cost of inventories of a service provider

1. To the extent that service providers have inventories, they measure them at the cost of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

4.11 Cost of agricultural produce harvested from biological assets

Section requires that inventories comprising agricultural produce that an entity has harvested from its biological assets shall be measured on initial recognition at their fair value less estimated costs to sell at the point of harvest. This becomes the cost of the inventories at that date for the application of this section.

4.12 Techniques for measuring cost, such as standard costing, retail method, and most recent purchase price

An entity may use techniques such as the standard cost method, the retail method, or the most recent purchase price for measuring the cost of inventories if the result approximates the cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency, and capacity utilisation. They are regularly reviewed and, if necessary, revised in light of current conditions. The retail method measures cost by reducing the sales value of the inventory by the appropriate percentage gross margin.

4.13 Cost formulas

- i. An entity shall measure the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects by using specific identification of their costs.
- ii. An entity shall measure the cost of inventories, other than those dealt with in, by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and used by the entity. For inventories with a different nature or use, different cost formulas may be justified. The last-in, first-out method (LIFO) is not permitted by this Standard.

1. Specific Identification Method

This method is used by businesses that deal with specialised, high-value products or project-based work.

Examples of Pakistani SMEs:

- Pak Swiss Knives (Custom Blade Manufacturing): This SME produces custom-made knives where each unit has a different cost, so it tracks inventory costs individually.
- Pak Modules (Solar Panel Customisation): Specialising in customised solar panel installations, the company tracks material costs separately for each project.
- Luxury Furniture by Interwood SMEs: Custom-made furniture SMEs track each piece's material cost using specific identification.

2. FIFO or Weighted Average Cost (For Regular Inventory)

Most SMEs dealing with fast-moving goods use FIFO or Weighted Average Cost for inventory.

Examples of Pakistani SMEs:

- Khaadi (Textile & Fashion SME): Uses FIFO to ensure older fabric stocks are used first to prevent obsolescence.
- Marhaba Laboratories (Herbal Pharmaceuticals): Uses FIFO to rotate perishable raw materials like herbs and essential oils.
- Chase Up & Imtiaz Supermarket (Retail & FMCG SMEs): Utilise Weighted Average Cost for grocery inventory management.
- Punjab Oil Mills (Edible Oils & Ghee Production): Uses Weighted Average Cost to calculate the cost of edible oil inventories.

3. LIFO Not Permitted

- Pakistan's SME sector, especially in pharma, textiles, and food industries, does not use LIFO, as it is against international standards (IFRS for SMEs).

4.14 Impairment of inventories

- Require an entity to assess at the end of each reporting period whether any inventories are impaired, i.e. the carrying amount is not fully recoverable (for example, because of damage, obsolescence, or declining selling prices). If an item (or group of items) of inventory is impaired, those paragraphs require the entity to measure the inventory at its selling price less costs to complete and sell and to recognise an impairment loss. Those paragraphs also require a reversal of a prior impairment in some circumstances
- Recognition as an expense** When inventories are sold, the entity shall recognize the carrying amount of those inventories as an expense in the period in which the related revenue is recognized.
- Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant, or equipment. Inventories allocated to another asset in this way are accounted for subsequently by the section of this Standard relevant to that type of asset.

4.15 Disclosures

- An entity shall disclose the following:
- the **accounting policies** adopted in measuring inventories, including the cost formula used.
- the total carrying number of inventories and the carrying amount in classifications appropriate to the entity;
- the amount of inventories recognised as an expense during the period;
- impairment losses recognised or reversed in profit or loss following Section Impairment of Assets; and
- The total carrying amount of inventories pledged as security for **Liabilities**.

Summary

This unit covers the principles of recognising and measuring inventories in financial statements. It discusses different costing methods such as FIFO, weighted average, and specific identification for various types of inventories. The unit explains the cost components, including purchase, conversion, and overhead costs. It highlights joint product and by-product costing used in industries like textiles, dairy, and edible oil. The treatment of impairment, inventory recognition as an expense, and disclosures are also covered. SMEs in Pakistan, such as Khadi, Punjab Oil Mills, and Marhaba Laboratories, apply these methods in their financial reporting. It also emphasises that LIFO is not permitted under IFRS standards. The unit ensures compliance with international accounting principles for SMEs.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015

Unit- 5

REVENUE

Complied by: Asia Batool

Reviewed by: Prof. Dr. S. M. Amir. Shah

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INTRODUCTION

Revenue is a fundamental concept in accounting and financial reporting, representing the income generated from business activities. It plays a crucial role in determining a company's financial health and performance. This unit focuses on the principles of revenue recognition, ensuring that income is recorded accurately and transparently. It covers different types of revenue sources, including the sale of goods, the rendering of services, and income from construction contracts. Additionally, the unit explains the measurement of revenue at fair value, taking into account trade discounts, volume rebates, and deferred payments. Special attention is given to interest, royalties, and dividends, along with disclosure requirements. Proper revenue recognition is essential for compliance with accounting standards and for providing stakeholders with reliable financial information.

OBJECTIVES

After this unit, you will be able to understand these concepts.

- Understand the scope of revenue recognition in different business transactions.
- Learn how to measure revenue at fair value, considering discounts and rebates.
- Identify the criteria for recognizing revenue from the sale of goods and services.
- Analyse revenue recognition in construction contracts using the percentage of completion method.
- Explore the accounting treatment for interest, royalties, and dividends.
- Understand the disclosure requirements for revenue in financial statements.

REVENUE

5.1 Scope of this section

- i. This section shall be applied in accounting for **revenue** arising from the following transactions and events:
 - a. the sale of goods (whether produced by the entity for sale or purchased for resale);
 - b. the rendering of services.
 - c. **construction contracts** in which the entity is the contractor; and
 - d. the use by others of entity **assets** yielding interest, royalties, or dividends.
- ii. Revenue or other **income** arising from some transactions and events is dealt with in other sections of this Standard:
 - a. **lease** agreements (see Section *Leases*).
 - b. dividends and other income arising from investments that are accounted for using the equity method (see Section *Investments in Associates* and Section *Investments in Joint Ventures*).
 - c. changes in the **fair value** of **financial assets** and **financial liabilities** or their disposal (see Section *Basic Financial Instruments* and Section *Other Financial Instrument Issues*).
 - d. changes in the fair value of **investment property** (see Section *Investment Property*).
 - e. initial **recognition** and changes in the fair value of **biological assets** related to **agricultural activity** (see Section 34 *Specialised Activities*); and
 - f. initial recognition of **agricultural produce**.

5.2 Measurement of revenue

- i. An entity shall measure revenue at the fair value of the consideration received or receivable. The fair value of the consideration received or receivable, takes into account the amount of any trade discounts, prompt settlement discounts, and volume rebates allowed by the entity.
- ii. An entity shall include in revenue only the gross inflows of economic benefits received and receivable by the entity on its account. An entity shall exclude from revenue all amounts collected on behalf of third parties, such as sales taxes, goods and services taxes and value-added taxes. In an agency relationship, an entity (the agent) shall include in revenue only the amount of its commission. The amounts collected on behalf of the principal are not revenue from the entity.

5.2.1 Deferred payment

When the inflow of cash or cash equivalents is deferred, and the arrangement constitutes in effect a financing transaction, the fair value of the consideration is the present value of all future receipts determined using an imputed rate of **interest**. A financing transaction arises when, for example, an entity provides interest-free credit to the buyer or accepts a note

receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. The imputed rate of interest is the more clearly determinable of the:

- (a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
- (b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

An entity shall recognise the difference between the present value of all future receipts and the nominal amount of the consideration as interest revenue by paragraphs 23.28 and 23.29 and Section 11.

5.2.2 Exchanges of goods or services

- i. An entity shall not recognise revenue:
 - a) when goods or services are exchanged for goods or services that are similar in value; or
 - b) when goods or services are exchanged for dissimilar goods or services, but the transaction lacks commercial substance.
- ii. An entity shall recognise revenue when goods are sold, or services are exchanged for dissimilar goods or services in a transaction that has commercial substance. In that case, the entity shall measure the transaction:
 - a. at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalent transferred.
 - b. if the amount under (a) cannot be measured reliably, then at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred; or
 - c. If the fair value of neither the goods nor the services received nor the goods or services given up can be measured reliably, then the **carrying amount** of the goods or services given up is adjusted by the amount of any cash or equivalent transferred.
- i. **Identification of the revenue transaction:** An entity usually applies the revenue recognition criteria in this section separately to each transaction. However, an entity applies the recognition criteria to the separately identifiable components of a single transaction when necessary to reflect the substance of the transaction. For example, an entity applies the recognition criteria to the separately identifiable components of a single transaction when the selling price of a product includes an identifiable amount for subsequent service. Conversely, an entity applies the recognition criteria to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions. For example, an entity applies the recognition criteria to two or more transactions together when it sells goods and, at the same time, enters into a separate agreement to repurchase the goods later, thus negating the substantive effect of the transaction.
- ii. Sometimes, as part of a sales transaction, an entity grants its customer a loyalty award that the customer may redeem in the future for free or discounted goods or services. In this case, by paragraph 23.8, the entity shall account for the award credits as a separately

identifiable component of the initial sales transaction. The entity shall allocate the fair value of the consideration received or receivable in respect of the initial sale between the award credits and the other components of the sale. The consideration allocated to the award credits shall be measured by reference to their fair value, i.e the amount for which the award credits could be sold separately.

Sale of goods

- i. An entity shall recognise revenue from the sale of goods when all the following conditions are satisfied:
 - a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
 - b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
 - c) The amount of revenue can be measured reliably;
 - d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.
- ii. The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the transfer of risks and rewards of ownership occurs at a time different from the transfer of legal title or the passing of possession.
- iii. An entity does not recognise revenue if it retains significant risks and rewards of ownership. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:
 - a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranties;
 - b) when the receipt of the revenue from a particular sale is contingent on the buyer selling the goods;
 - c) when the goods are shipped subject to installation and the installation is a significant part of the contract that has not yet been completed; and
 - d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract, or at the buyer's sole discretion without any reason, and the entity is uncertain about the probability of return.
- IV. If an entity retains only an insignificant risk of ownership, it can recognise the transaction as a sale and record the revenue. For instance:
 - a. A seller recognises revenue even if it retains legal title, as long as the purpose is solely to ensure payment collection.
 - b. Revenue is also recognised when a refund policy exists for faulty or unsatisfactory

goods, provided the entity can reliably estimate returns.

5.3 Rendering of services

i. When the outcome of a transaction involving the rendering of services can be estimated reliably, an entity shall recognise revenue associated with the transaction by reference to the stage of completion of the transaction at the end of the reporting period (sometimes referred to as the percentage of completion method). The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- a. The amount of revenue can be measured reliably.
 - b. It is probable that the economic benefits associated with the transaction will flow to the entity.
 - c. the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
 - d. The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.
- ii. When services are performed by an indeterminate number of acts over a specified period, an entity recognises revenue on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other act, the entity postpones recognition of revenue until the significant act is executed.
- iii. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, an entity shall recognise revenue only to the extent of the expenses recognized that are

5.4 CONSTRUCTION CONTRACTS

- i. When the outcome of a construction contract can be estimated reliably, an entity shall recognize contract revenue and contract costs associated with the construction contract as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period (often referred to as the percentage of completion method). Reliable estimation of the outcome requires reliable estimates of the stage of completion, future costs, and collectability of billings.
- ii. The requirements of this section are usually applied separately to each construction contract. However, in some circumstances, it is necessary to apply this section to the separately identifiable components of a single contract or to a group of contracts together to reflect the substance of a contract or a group of contracts.
- iii. When a contract covers several assets, the construction of each asset shall be treated as a separate construction contract when:
 - (c) Separate proposals have been submitted for each asset.
 - (d) each asset has been subject to separate negotiation, and the contractor and customer can accept or reject that part of the contract relating to each asset; and
 - (e) The costs and revenues of each asset can be identified.

- iv. A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:
 - i. The group of contracts is negotiated as a single package;
 - ii. the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - iii. The contracts are performed concurrently or in a continuous sequence.

5.5 Percentage of completion method

This method is used to recognise revenue from **rendering services** (see paragraphs 5.5 -i & ii) and from **construction contracts** (see paragraphs 5.6 i-iv). An entity shall review and, when necessary, revise the estimates of revenue and costs as the service transaction or construction contract progresses.

- a) An entity shall determine the stage of completion of a transaction or contract using the method that measures most reliably the work performed. Possible methods include:
 - b) the proportion that the costs incurred for work performed to date bear to the estimated total costs. Costs incurred for work performed to date do not include costs relating to future activity, such as for materials or prepayments.
 - c) Surveys of work performed.
 - d) completion of a physical proportion of the service transaction or contract work.
 - e) Progress payments and advances received from customers often do not reflect the work performed.
- a. An entity shall recognize costs that relate to future activity on the transaction or contract, such as for materials or prepayments, as an asset if it is probable that the costs will be recovered.
- b. An entity shall recognize as an expense immediately any costs whose recovery is not probable.
- c. When the outcome of a contract cannot be estimated reliably:
 - i. An entity shall recognise revenue only to the extent of contract costs incurred that it is probable will be recoverable; and
 - ii. The entity shall recognise contract costs as an expense in the period in which they are incurred.
- d. When it is probable that total contract costs will exceed total contract revenue on a contract, the expected loss shall be recognised as an expense immediately, with a corresponding provision for an **onerous contract**.
- e. If the collectability of an amount already recognised as contract revenue is no longer probable, the entity shall recognise the uncollectable amount as an expense instead of as an adjustment of the amount of contract revenue.

5.6 Interest, royalties, and dividends

An entity shall recognise revenue arising from the use by others of entity assets yielding interest, royalties, and dividends on the basis set out in paragraph 23.29 when:

- i. The economic benefits associated with the transaction will probably flow to the entity; and
 - ii. The amount of the revenue can be measured reliably.
- b) An entity shall recognise revenue on the following bases:
- i. Interest shall be recognized using the **effective interest method** as described in paragraphs 11.15–11.20.
 - ii. royalties shall be recognized on an accrual basis by the substance of the relevant agreement; and
 - iii. Dividends shall be recognised when the shareholder's right to receive payment is established.

5.7 Disclosures

5.7.1 General disclosures about revenue

An entity shall disclose:

- a) the **accounting policies** adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services; and
- b) the amount of each category of revenue recognised during the period, showing separately, at a minimum, revenue arising from:
 - (i) the sale of goods;
 - (ii) the rendering of services;
 - (iii) interest;
 - (iv) royalties;
 - (v) dividends;
 - (vi) commissions;
 - (vii) government grants; and
 - (viii) any other significant types of revenue.

5.7.2 Disclosures relating to revenue from construction contracts

- a. An entity shall disclose the following:
 - i. The amount of contract revenue recognised as revenue in the period;
 - ii. the methods used to determine the contract revenue recognised in the period; and
 - iii. The methods used to determine the stage of completion of contracts in progress.
- b. An entity shall present:
 - i. the gross amount due from customers for contract work, as an asset; and
 - ii. The gross amount due to customers for contract work, as a liability.

Summary

Revenue is a crucial aspect of financial reporting, representing the income earned by an entity through various business activities. This unit explores different revenue sources, measurement techniques, and recognition criteria. It discusses the sale of goods, rendering of services, and construction contracts, including the percentage of completion method. It also covers revenue from interest, royalties, and dividends. The importance of accurate revenue measurement, fair value assessment, and proper disclosures is emphasised to ensure transparency in financial statements.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015

Unit- 6

**PROPERTY, PLANT AND
EQUIPMENT**

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INTRODUCTION

Property, Plant, and Equipment (PPE) include tangible assets used in business operations for more than one period. This section defines PPE and its recognition, requiring assets to provide future economic benefits and have a reliable cost measurement. Initial measurement is based on cost, including associated expenses like installation and delivery. After initial recognition, entities choose between the cost model and the revaluation model for reporting. Depreciation is allocated systematically over the asset's useful life, and impairment reviews ensure accurate valuation. The unit also discusses derecognition of when an asset is disposed of or no longer provides benefits.

OBJECTIVES

After this unit, you will be able to understand these concepts:

- To understand the recognition and measurement of PPE in financial statements.
- To differentiate between the cost model and revaluation model for PPE valuation.
- To learn the various depreciation methods and their application.
- To explore impairment assessment and its impact on financial reporting.
- To understand disclosure requirements related to PPE in IFRS for SMEs.

PROPERTY, PLANT, AND EQUIPMENT

6.1 Scope of this section

- a. This section applies to accounting for **property, plant, and equipment** and accounting for **investment property** whose **fair value** cannot be measured reliably without undue cost or effort on an ongoing basis. Section 16 *Investment Property* applies to investment property whose fair value can be measured reliably without undue cost or effort.
- b. Property, plant, and equipment are tangible **assets** that:
 - i. are held for use in the production or supply of goods or services, for rental to others, or administrative purposes; and
 - ii. are expected to be used during more than one period.
- c. Property, plant, and equipment do not include:
 - i. **Biological assets** related to **agricultural activity**
 - ii. mineral rights and mineral reserves, such as oil, natural gas, and similar non-regenerative resources.

6.2 Recognition

- i. An entity shall apply the recognition criteria in determining whether to recognise an item of property, plant, or equipment. Consequently, the entity shall recognise the cost of an item of property, plant, and equipment as an asset if, and only if:
 - ii. It is probable that future economic benefits associated with the item will flow to the entity; and
 - iii. The cost of the item can be measured reliably.
- b. Items such as spare parts, stand-by equipment, and servicing equipment are recognised by this section when they meet the definition of property, plant, and equipment. Otherwise, such items are classified as inventory.
- c. Parts of some items of property, plant and equipment may require replacement at regular intervals (for example, the roof of a building). An entity shall add to the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the replacement part is expected to provide incremental future benefits to the entity. The carrying amount of those parts that are replaced is derecognized with paragraphs regardless of whether the replaced parts had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, the entity may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

Components of an item of property, plant and equipment have significantly different patterns of consumption of economic benefits, an entity shall allocate the initial cost of the

asset to its major components and depreciate each such component separately over its useful life.

- d. The condition of continuing to operate an item of property, plant, and equipment (for example, a bus) may be performing regular major inspections for faults, regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognized in the carrying amount of the item of property, plant, and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous major inspection (as distinct from physical parts) is derecognized. This is done regardless of whether the cost of the previous major inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.
- e. Land and buildings are separable assets, and an entity shall account for them separately, even when they are acquired together.

6.3 Measurement of recognition

An entity shall measure an item of property, plant and equipment at initial recognition at its cost.

- a) Elements of cost

The cost of an item of property, plant, and equipment comprises all of the following:

- i. its purchase price, including legal and brokerage fees, import duties, and non-refundable purchase taxes, after deducting trade discounts and rebates.
 - ii. any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. These can include the costs of site preparation, initial delivery and handling, installation and assembly, and testing of functionality.
 - iii. the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.
- i. The following costs are not costs of an item of property, plant, and equipment, and an entity shall recognise them as an expense when they are incurred: Costs of opening a new facility;
 - ii. costs of introducing a new product or service (including costs of advertising and promotional activities);

- (a) costs of conducting business in a new location or with a new class of customer (including costs of staff training);
- (b) administration and other general overhead costs; and
- (c) borrowing costs

The income and related expenses of incidental operations during the construction or development of an item of property, plant, and equipment are recognised in profit or loss if those operations are not necessary to bring the item to its intended location and operating condition.

6.3.1 Measurement of cost

The cost of an item of property, plant, and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the cost is the present value of all future payments.

6.3.2 Exchanges of assets

An item of property, plant, or equipment may be acquired in exchange for a non-monetary asset, or assets, or a combination of monetary and non-monetary assets. An entity shall measure the cost of the acquired asset at fair value unless

- a) The exchange transaction lacks commercial substance, or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. In that case, the asset's cost is measured at the carrying amount of the asset given up.

6.4 Measurement after initial recognition

An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant, and equipment. An entity shall apply the cost model to investment property whose fair value cannot be measured reliably without undue cost or effort. An entity shall recognise the costs of day-to-day servicing of an item of property, plant, and equipment in profit or loss in the period in which the costs are incurred.

6.4.1 Cost-model

An entity shall measure an item of property, plant and equipment after initial recognition at cost less any accumulated depreciation and any accumulated impairment losses.

6.4.2 Revaluation model

An entity shall measure an item of property, plant and equipment whose fair value can be measured reliably at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ **materially** from that which would be determined using fair value at the end of the reporting **period**.

- 1.. Determining fair value. If an item of property, plant and equipment is revalued, the entire

class of property, plant and equipment to which that asset belongs shall be revalued.

- i. If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognized in **other comprehensive income** and accumulated in **equity** under the heading of revaluation surplus. However, the increase shall be recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.
- ii. If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

6.5 Depreciation

- i. If the major components of an item of property, plant and equipment have significantly different patterns of consumption of economic benefits, an entity shall allocate the initial cost of the asset to its major components and depreciate such components separately over its useful life. Other assets shall be depreciated over their useful lives as a single asset. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated.
- ii. The depreciation charge for each period shall be recognised in profit or loss unless another section of this Standard requires the cost to be recognised as part of the cost of an asset. For example, the depreciation of manufacturing property, plant and equipment is included in the costs of inventories.

6.6 Depreciable amount and depreciation period

An entity shall allocate the **depreciable amount** of an asset on a systematic basis over its useful life.

- i. Factors such as a change in how an asset is used, significant unexpected wear and tear, technological advancement and changes in market prices may indicate that the **residual value** or useful life of an asset has changed since the most recent annual **reporting date**. If such indicators are present, an entity shall review its previous estimates and, if current expectations differ, amend the residual value, depreciation method or useful life. The entity shall account for the change in residual value, depreciation method or useful life as a change in an **accounting estimate**.
- ii. Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases when the asset is derecognized. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

An entity shall consider all the following factors in determining the useful life of an asset:

- (a) The expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
- (b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used, the repair and maintenance program, and the care and maintenance of the asset while idle.
- (c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.

Legal or similar limits on the use of the asset, such as the expiry dates of related **leases**

6.7 Depreciation method

- i. An entity shall select a depreciation method that reflects the pattern in which it expects to consume the asset's future economic benefits. The possible depreciation methods include the straight-line method, the diminishing balance method, and a method based on usage, such as the units of production method.
- ii. If there is an indication that there has been a significant change since the last annual reporting date in the pattern by which an entity expects to consume an asset's future economic benefits, the entity shall review its present depreciation method and, if current expectations differ, change the depreciation method to reflect the new pattern. The entity shall account for the change as a change in an accounting estimate.

6.8 Impairment

6.8.1 Recognition and measurement of impairment

At each reporting date, an entity shall apply Section 27 Impairment of Assets to determine whether an item or group of items of property, plant, and equipment is impaired and, if so, how to recognize and measure the impairment loss. That section explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognizes or reverses an impairment loss.

6.8.2 Compensation for Impairment

An entity shall include in profit or loss compensation from third parties for items of property, plant, and equipment that were impaired, lost, or given up only when the compensation becomes receivable.

6.8.3 Property, plant, and equipment held for sale

A plan to dispose of an asset before the previously expected date is an indicator of impairment that triggers the calculation of the asset's recoverable amount to determine whether the asset is impaired.

6.9 Derecognition

An entity shall derecognise an item of property, plant, and equipment:

- a) on disposal; or

- b) when no future economic benefits are expected from its use or disposal.
- i. An entity shall recognise the **gain** or loss on the **derecognition** of an item of property, plant, and equipment in profit or loss when the item is derecognised (unless Section Leases requires otherwise on a sale and leaseback). The entity shall not classify such gains as **revenue**. In determining the date of disposal of an item, an entity shall apply the criteria in Section Revenue for recognising revenue from the sale of goods. The section applies to disposal by a sale and leaseback.
- ii. An entity shall determine the gain or loss arising from the derecognition of an item of property, plant and equipment as the difference between the net disposal proceeds, if any, and the carrying amount of the item

6.10 Disclosures

An entity shall disclose the following for each class of property, plant, and equipment determined and separately for investment property carried at cost less accumulated depreciation and impairment:

- a) the measurement bases used for determining the gross carrying amount;
- b) the depreciation methods used;
- c) the useful lives or the depreciation rates used;
- d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the reporting period; and
- e) a reconciliation of the carrying amount at the beginning and end of the reporting period, showing separately:
 - vi. additions;
 - vii. disposals;
 - viii. acquisitions through business combinations;

Summary

This unit discusses the accounting treatment for Property, Plant, and Equipment (PPE) under IFRS for SMEs. It explains the recognition, measurement, depreciation, impairment, and derecognition of PPE. The section applies to tangible assets used for production, rental, or administrative purposes, excluding biological assets and mineral resources. PPE is initially measured at cost, including purchase price and directly attributable costs. After initial recognition, it can be measured using either the cost model or the revaluation model. Depreciation methods vary based on asset usage, and impairment reviews ensure assets are not overstated. Finally, the unit outlines disclosure requirements for financial reporting.

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<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015

Unit-7

**INTANGIBLE ASSETS OTHER THAN
GOODWILL**

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INTRODUCTION

Intangible assets play a crucial role in modern businesses, especially in sectors like technology, pharmaceuticals, and branding. These assets include trademarks, patents, software, and licenses, which provide long-term benefits despite lacking physical substance. The IFRS for SMEs provides guidelines for their recognition, measurement, and amortisation to ensure consistency in financial reporting. An intangible asset must have a measurable cost and provide future economic benefits to be recognised. The unit also discusses acquisition methods, such as purchases, government grants, or business combinations. After initial recognition, these assets are amortised over their useful life to reflect consumption. If an asset's value declines, an impairment review is conducted, and losses are recorded if necessary. The unit concludes with disclosure requirements to ensure transparency and compliance with international accounting standards.

OBJECTIVES

After this unit, you will be able to understand these concepts.

- To understand the definition and characteristics of intangible assets under IFRS for SMEs.
- To learn the recognition criteria and conditions for recording intangible assets.
- To explore different measurement methods, including cost and fair value approaches.
- To examine amortisation methods and their impact on financial statements.
- To understand impairment reviews and their role in ensuring accurate asset valuation.
- To analyse disclosure requirements for transparent financial

7.1 Scope of this section

This section applies to accounting for all **intangible assets** other than **goodwill** and intangible assets held by an entity for sale in the ordinary course of business-

An intangible asset is an identifiable non-monetary **asset** without physical substance. Such an asset is identifiable when:

- (a) It is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or **liability**; or
- (b) It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or other rights and obligations.

This section does not apply to the following:

- (a) financial assets; or
- (b) mineral rights and mineral reserves, such as oil, natural gas and similar non-regenerative resources

In the Pakistani SME context, an example of intangible assets under IFRS for SMEs could be a small IT company in Karachi that develops and sells software licenses. The software, being a non-monetary asset without physical substance, qualifies as an intangible asset because it is separable and can be sold or licensed to customers.

Another example is a pharmaceutical startup in Lahore that holds patents for locally developed medicines. These patents, arising from contractual and legal rights, are also classified as intangible assets. Similarly, small textile businesses in Faisalabad may register brand trademarks for their locally manufactured fabrics, ensuring market recognition and exclusivity. These intangible assets add value to SMEs by strengthening their market position and enhancing financial reporting transparency under IFRS for SMEs.

7.2 Recognition

7.2.1 General principle for recognizing intangible assets

An entity shall apply the **recognition** in determining whether to recognise an intangible asset. Consequently, the entity shall recognise an intangible asset as an asset if, and only if:

- (a) It is **probable** that the expected future economic benefits that are attributable to the asset will flow to the entity.
- (b) The cost or value of the asset can be measured reliably; and
- (c) The asset does not result from expenditure incurred internally on an intangible item.
 - i. An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the **useful life** of the asset.
 - ii. An entity uses judgment to assess the degree of certainty attached to the

flow of future economic benefits that are attributable to the use of the asset based on the evidence available at the time of initial recognition, giving greater weight to external evidence.

7.2.2 Acquisition as part of a business combination

An intangible asset acquired in a **business combination** shall be recognised unless its **fair value** cannot be measured reliably without undue cost or effort at the acquisition date.

7.3 Initial measurement

- a. An entity shall measure an intangible asset initially at cost.

7.3.1 Separate acquisition

The cost of a separately acquired intangible asset comprises:

Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

- a) any directly attributable cost of preparing the asset for its intended use.

7.3.2 Acquisition as part of a business combination

If an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date.

7.3.3 Acquisition by way of a government grant

If an intangible asset is acquired by way of a **government grant**, the cost of that intangible asset is its fair value at the date the grant is received or receivable.

7.3.4 Exchanges of assets

An intangible asset may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. An entity shall measure the cost of such an intangible asset at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. In that case, the asset's cost is measured at the **carrying amount** of the asset given up.

7.3.5 Internally generated intangible assets

An entity shall recognise expenditure incurred internally on an intangible item, including all expenditure for both **research** and **development** activities, as an **expense** when it is incurred unless it forms part of the cost of another asset that meets the recognition criteria in this Standard.

As examples of applying the preceding paragraph, an entity shall recognise expenditure on the following items as an expense and shall not recognise such expenditure as intangible assets:

Internally generated brands, logos, publishing titles, customer lists and items similar in substance.

- (a) start-up activities (ie, start-up costs), which include establishment costs such as legal

and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie, pre-opening costs), and expenditure for starting new operations or launching new products or processes (ie, pre-operating costs)

- (b) training activities.
- (c) advertising and promotional activities.
- (d) relocating or reorganising part or all of an entity; and
- (e) internally generated goodwill.

7.4 Past expenses not to be recognised as an asset

Expenditure on an intangible item that was initially recognised as an expense shall not be recognised at a later date as part of the cost of an asset.

7.5 Measurement after Recognition

An entity shall measure intangible assets at cost less any accumulated **amortisation** and any accumulated **impairment losses**. The requirements for amortisation are set out in this section. The requirements for recognition of impairment are set out in Section Impairment of Assets.

7.6 Useful life

For this Standard, all intangible assets shall be considered to have a finite useful life. The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.

If the useful life of an intangible asset cannot be established reliably, the life shall be determined based on management's best estimate but shall not exceed ten years.

7.6.1 Amortisation period and amortisation method

An entity shall allocate the **depreciable amount** of an intangible asset on a systematic basis over its useful life. The amortisation charge for each period shall be recognised as an expense, unless another section of this Standard requires the cost to be recognised as part of the cost of an asset, such as **inventories** or **property, plant, and equipment**.

Amortisation begins when the intangible asset is available for use, ie, when it is in the location and condition necessary for it to be usable in the manner intended by management. Amortisation ceases when the asset is derecognized. The entity shall choose an amortisation method that reflects the pattern in which it expects to consume the asset's future economic benefits. If the entity cannot determine that pattern reliably, it shall use the straight-line method.

7.6.2 Residual value

An entity shall assume that the **residual value** of an intangible asset is zero unless:

- (a) There is a commitment by a third party to purchase the asset at the end of its useful life; or
- (b) There is an **active market** for the asset and:
 - (i) residual value can be determined by reference to that market; and
 - (ii) It is probable that such a market will exist at the end of the asset's useful life.

7.6.3 Review of amortisation period and amortisation method

Factors such as a change in how an intangible asset is used, technological advancement, and changes in market prices may indicate that the residual value or useful life of an intangible asset has changed since the most recent annual **reporting date**. If such indicators are present, an entity shall review its previous estimates and, if current expectations differ, amend the residual value, amortisation method, or useful life. The entity shall account for the change in residual value, amortisation method, or useful life as a **change in an accounting estimate**.

7.7 Recoverability of the carrying amount—impairment losses

That section explains when and how an entity reviews the carrying amount of its assets, how it determines the **recoverable amount** of an asset, and when it recognises or reverses an impairment loss.

Example of Impairment Loss in the Pakistani Context

A small textile manufacturing company in Faisalabad purchases a weaving machine for PKR 5 million and records it as Property, Plant, and Equipment (PPE). Due to unexpected market downturns and declining demand for its fabrics, the company realises that the machine is generating lower-than-expected cash flows.

Following IFRS for SMEs, the company conducts an impairment review to determine whether the machine's carrying amount (PKR 5 million) exceeds its recoverable amount. If the fair value of the machine (after considering selling costs) is now only PKR 3.5 million, an impairment loss of PKR 1.5 million is recorded in the financial statements.

If market conditions improve and the machine's value increases in the future, the company may be allowed to reverse part of the impairment loss, ensuring accurate financial reporting as per IFRS for SMEs.

7.8 Retirements and disposals

An entity shall derecognise an intangible asset, and shall recognise a **gain** or loss in **profit or loss**:

- (a) on disposal; or
- (b) when no future economic benefits are expected from its use or disposal.

7.9 Disclosures

An entity shall disclose the following for each class of intangible assets:

- a) the useful lives or the amortisation rates used;
- (a) The amortisation methods used;
- (b) the gross carrying amount and any accumulated
- (c) amortisation (aggregated with accumulated impairment losses) at the beginning and end of the **reporting period**;
- (d) the line item(s) in the **statement of comprehensive income** (and in the **income statement**, if presented) in which any amortisation of intangible assets is included; and
- (e) a reconciliation of the carrying amount at the beginning and end of the reporting period, showing separately:
 - (i) additions;
 - (ii) disposals;
 - (iii) acquisitions through business combinations;
 - (iv) amortisation;
 - (v) impairment losses; and
 - (vi) Other changes.

This reconciliation need not be presented for prior periods.

An entity shall also disclose:

- (a) a description, the carrying amount, and remaining amortisation period of any individual intangible asset that is **material** to the entity's **financial statements**;
- (b) for intangible assets acquired by way of a government grant and initially recognised at fair value (see paragraph 18.12):
 - (i) the fair value initially recognised for these assets; and
 - (ii) their carrying amounts.
- (c) the existence and carrying amounts of intangible assets to which the entity has restricted title or that are pledged as security for liabilities; and

- (d) The amount of contractual commitments for the acquisition of intangible assets.

An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period (ie, the amount of expenditure incurred internally on research and development that has not been capitalised as part of the cost of another asset that meets the recognition criteria in this Standard).

Summary

This unit covers the accounting treatment of intangible assets other than goodwill under IFRS for SMEs. It defines intangible assets as identifiable non-monetary assets without physical substance, such as patents, copyrights, and trademarks. The unit explains the recognition criteria, requiring intangible assets to provide future economic benefits and have measurable costs. Initial measurement is at cost, including purchase price and directly attributable costs. After recognition, intangible assets are amortised systematically over their useful life. If an asset's recoverable amount falls below its carrying value, an impairment loss is recognised. The unit also covers retirement and disposals, where an asset is derecognised if it no longer provides economic benefits. Lastly, disclosure requirements ensure transparency in financial reporting.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015

Unit- 8

RELATED PARTY DISCLOSURES

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INTRODUCTION

This section defines related parties in financial reporting, including individuals and entities that influence a company's financial position. It highlights key management personnel, control, joint control, and significant influence as criteria for related party identification. The purpose is to ensure transparency and accountability in financial statements. It emphasizes the impact of related party transactions on financial performance and the need for proper disclosures. Businesses must assess relationships based on substance, not just legal form. The section also clarifies which entities and individuals do not qualify as related parties. Proper disclosure prevents conflicts of interest and enhances financial integrity.

OBJECTIVES

After reading this unit, you will be able to:

- Identify persons or entities that qualify as related parties.
- Ensure proper disclosure of related party transactions in financial statements.
- Provide transparency on financial influence and control within entities.
- Define types of relationships that affect financial reporting.
- Outline specific disclosure requirements to prevent misleading financial data.
- Assist SMEs in complying with international accounting standards.

Related Party Disclosures

8.1 Scope of this section

This section requires an entity to include in its **financial statements** the disclosures necessary to draw attention to the possibility that its **financial position** and **profit or loss** have been affected by the existence of **related parties** and by transactions and outstanding balances with such parties.

8.2 Related party defined

A related party is a person or entity that is related to the entity that is preparing its financial statements (the reporting entity):

- a. a person or a close member of that person's family is related to a reporting entity if that person:
 - i. is a member of the key management personnel of the reporting entity or a parent of the reporting entity.
 - ii. has control or joint control over the reporting entity; or
 - iii. has a significant influence over the reporting entity.
- i. An entity is related to a reporting entity if any of the following conditions apply: The entity and the reporting entity are members of the same group (which means that each parent, subsidiary, and fellow subsidiary is related to the others).
 - ii. One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
 - iii. Both entities are joint ventures of the same third entity.
 - iv. One entity is a joint venture of a third entity, and the other entity is an associate of the third entity.
 - v. The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
 - vi. The entity is controlled or jointly controlled by a person identified in (a).
 - vii. The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or the parent of the reporting entity.
 - viii. A person identified in (a)(ii) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).
- b. In considering each possible related party relationship, an entity shall assess the substance of the relationship and not merely the legal form. In the context of this Standard, the following are not necessarily related parties:
 - i. two entities simply because they have a director or other member of key management personnel in common;
 - ii. Two venturers simply because they share joint control over a joint venture;
 - iii. any of the following simply by. Their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process):
 - a. providers of finance;
 - b. trade unions;

- c. public utilities; or
- d. government departments and agencies.
- iv. A customer, supplier, franchisor, distributor, or general agent with whom an entity transacts a significant volume of business, merely by the resulting economic dependence.

8.2.1 Key Takeaways:

8.2.1.1 Individuals as Related Parties

- i. Key management personnel (e.g., executives, board members).
- ii. Individuals with control, joint control, or significant influence over the reporting entity.
- iii. Close family members of such individuals.

8.2.1.2 Entities as Related Parties

- i. Entities within the same group (e.g., parent-subsidary relationships).
- ii. Associates and joint ventures of the reporting entity or its group members.
- iii. Entities that share common joint venture relationships.
- iv. Post-employment benefit plans are linked to the reporting entity.
- v. Entities controlled, jointly controlled, or significantly influenced by related individuals.
- vi. Entities providing key management personnel services to the reporting entity.

Example 1: Family-Owned Textile Business

Business: ABC Textiles (SME in Faisalabad)

- Owner: Ali Khan
- Related Parties:
 - Ali Khan's brother owns XYZ Weaving Mills, which supplies fabric to ABC Textiles → Related as a close family member (8.2(a))
 - Ali Khan is also a director in LMN Exports, which sells ABC Textiles' products internationally → Related as he has significant influence (8.2(a)(iii))

Example 2: IT Startup in Lahore

Business: Tech Solutions Pvt. Ltd. (SME in Lahore)

- Owner: Sara Ahmed
- Related Parties:
 - Sara Ahmed is also a board member of a software house, Soft Innovate Ltd., that provides services to Tech Solutions → Related as she is key management personnel in both entities (8.2(a)(i))

- Tech Solutions and another SME, Code Crafters Pvt. Ltd., are joint ventures of Invest Pak Ltd. → Related under joint venture criteria (8.2(b)(iii))

8.3 Disclosures

8.3.1 Disclosure of parent-subsidiary relationships

Relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been **related party transactions**. An entity shall disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so (if any) shall also be disclosed.

8.3.2 Disclosure of key management personnel

8.3.3 compensation

Key management personnel (KMP) are individuals who have the authority and responsibility to **plan, direct, and control** an entity's activities, either directly or indirectly. This includes executives, senior managers, and members of the board of directors, whether they hold executive or non-executive positions. Their decisions significantly impact the organisation's financial health, strategic direction, and operational success.

Compensation for key management personnel includes **all forms of employee benefits** as outlined in accounting standards. These benefits can be monetary or non-monetary and may include salaries, bonuses, pensions, health benefits, and other allowances. Additionally, **share-based payments**, such as stock options or performance shares, are considered part of their remuneration. If an entity does not directly pay a KMP but instead their compensation is provided by the **parent company or a shareholder**, it is still regarded as part of their total compensation.

Furthermore, when a parent entity compensates KMP on behalf of its subsidiary for services rendered to the subsidiary, these payments must also be disclosed in financial statements. Proper disclosure of **KMP compensation** ensures transparency, helps stakeholders understand financial obligations, and prevents potential conflicts of interest within an organisation.

An entity shall disclose the key management personnel's compensation in total.

8.3.4 Disclosure of related party transactions

1. A related party transaction is a transfer of resources, services, or obligations between a reporting entity and a related party, regardless of whether a price is charged. Examples of related party transactions that are common to SMEs include, but are not limited to:
 - (a) transactions between an entity and its principal **owner(s)**;
 - (b) transactions between an entity and another entity when both entities are under the common control of a single entity or person; and
 - (c) transactions in which an entity or person that controls the reporting entity incurs **expenses** directly that otherwise would have been borne by the reporting entity.
2. If an entity has related party transactions, it shall disclose the nature of the related party relationship as well as information about the transactions, outstanding balances, and commitments necessary for an understanding of the potential effect of

the relationship on the financial statements. Those disclosure requirements are in addition to the requirements to disclose key management personnel compensation. At a minimum, disclosures shall include:

- (d) The amount of the transactions;
- (e) the amount of outstanding balances and:
- (i) their terms and conditions, including whether they are secured and the nature of the consideration to be provided in settlement; and
- (ii) details of any guarantees given or received.
- (f) provisions for uncollectable receivables related to the amount of outstanding balances; and
- (g) The expense recognised during the period in respect of bad or doubtful debts due from related parties.

Such transactions could include purchases, sales, or transfers of goods or services; leases; guarantees; and settlements by the entity on behalf of the related party or vice versa.

3. An entity shall make the disclosures required by paragraph
4. separately for each of the following categories:
 - (h) entities with control, joint control, or significant influence over the entity;
 - (i) entities over which the entity has control, joint control or significant influence;
 - (j) key management personnel of the entity or its parent (in the aggregate); and other related parties.
5. An entity is exempt from the disclosure requirements of paragraph 2 of 8.3.3 about:
 - (a) a **state** (a national, regional or local government) that has control, joint control or significant influence over the reporting entity; and
 - (b) another entity that is a related party because the same state has control, joint control or significant influence over both the reporting entity and the other entity.

However, the entity must still disclose a parent-subsidiary relationship as required by paragraph 8.3.1
6. The following are examples of transactions that shall be disclosed if they are with a related party:
 - (c) purchases or sales of goods (finished or unfinished);
 - (d) purchases or sales of property and other **assets**;
 - (e) rendering or receiving of services;
 - (f) leases;
 - (g) transfers of **research and development**.
 - (h) transfers under license agreements;
 - (i) transfers under finance arrangements (including loans and equity contributions in cash or in-kind);
 - (j) provision of guarantees or collateral;
 - (k) settlement of **liabilities** on behalf of the entity or by the entity on behalf of another party; and
 - (l) participation by a parent or subsidiary in a **defined benefit plan** that shares risks between group entities.
7. An entity shall not state that related party transactions were made on terms equivalent to those that prevail in arm's length transactions unless such terms can be substantiated.
8. An entity may disclose items of a similar nature in the aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

Summary

The related party disclosure section ensures that financial statements reflect transactions and balances with related parties to maintain transparency. It defines related parties, including key management personnel, controlling entities, and joint ventures. It requires businesses to disclose relationships, transactions, and outstanding balances to highlight potential financial impacts. Disclosure includes details such as transaction amounts, outstanding balances, guarantees, and terms. Some entities, such as government-related entities, may have exemptions. Proper disclosure prevents financial misrepresentation and ensures compliance with accounting standards. This section helps stakeholders understand the financial effects of related party relationships.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

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Unit - 9

MISCELLANEOUS

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INTRODUCTION

This unit explores various financial aspects that impact an entity's financial statements and reporting transparency. It covers provisions, which are liabilities of uncertain timing or amount, and collections, including receivables and revenue recognition. The concept of economic interest is discussed, emphasizing financial dependencies and relationships with funding bodies. Expense attribution and allocation methods ensure accurate cost distribution across departments. Contributions receivable, such as pledges and bequests, are examined under IFRS for SMEs. The unit also highlights disclosure requirements for financial transactions. Finally, it addresses the transition process for entities adopting IFRS for SMEs, ensuring compliance with international standards.

OBJECTIVES

After reading this unit, you will be able to:

- Understand provisions and their role in financial reporting.
- Learn about collections, including accounts receivable and loan repayments.
- Analyse economic interest and its disclosure requirements.
- Identify proper methods for expense attribution and allocation.
- Recognise the treatment of contributions receivable, including pledges and bequests.
- Understand the transition process and disclosure requirements for IFRS for SMEs.

9.1 Provision Collections

Provisions are liabilities of uncertain timing or amount, recognised when an entity has a **present obligation** due to past events, the settlement will probably require an outflow of resources, and the amount can be estimated reliably.

Example:

A small manufacturing company faces a lawsuit for defective products. Based on legal advice, it estimates a **50% probability** of paying \$50,000 in damages. The company recognises a provision of **\$25,000** in its financial statements.

9.1.1 Nature of Collections

Collections refer to **amounts received or recoverable**, such as accounts receivable, loan repayments, or other claims. For SMEs, collection policies must align with **revenue recognition principles** under IFRS.

Example:

9.1.2 A small retail business allows customers to pay in instalments. It records the amounts as **accounts receivable** and recognises revenue when goods are delivered. If a customer defaults, the business may create a **provision for doubtful debts**. **Disclosures**

SMEs must disclose information on provisions, contingent liabilities, and contingent assets in financial statements, including:

- Nature and expected timing of the outflow.
- Estimates of financial impact.
- Uncertainties affecting the provision.
- Amount of any expected reimbursements.

Example:

A small IT company discloses a provision of \$10,000 for potential software warranty claims in its financial notes, explaining that past claims averaged 2% of sales.

9.2 Reporting related organizations

In financial reporting, related organisations refer to entities that have economic connections through control, influence, or funding relationships. IFRS for SMEs (2015) requires businesses to disclose these relationships to ensure transparency and fair financial reporting.

9.2.1 Economic interest

An economic interest exists when an entity derives financial benefits from another entity without necessarily having ownership or control. This could be through shared profits, financial dependencies, or indirect influence over operations.

Example:

A small nonprofit organisation partners with a **for-profit training institute** to provide subsidised education programs. While the nonprofit does not control the institute, it receives a **percentage of revenue** generated from referred students. This creates an **economic interest** that must be disclosed in financial statements.

9.2.2 Relationships with funding bodies

Many SMEs, especially nonprofits and startups, receive financial support from **government agencies, private investors, or grants**. IFRS for SMEs (2015) requires disclosure of these funding relationships if they influence the entity's financial position or operations.

Example:

A small tech startup receives a **grant from a government innovation fund** to develop new software. The funding body does not own the startup but **monitors its financial performance and sets conditions** for continued support. This relationship must be reported to highlight external financial influence.

9.2.3 Disclosure of Economic Interest

Under IFRS for SMEs (2015), the disclosure of economic interest in related organisations falls under Section 33 (Related Party Disclosures) and Section 34 (Specialised Activities). These sections require SMEs to provide transparent financial information regarding relationships that may affect financial position or performance.

Key Disclosure Requirements (Sections 33 & 34):

1. Nature of Economic Interest – The entity must explain how it benefits from a related organisation without direct ownership or control.
2. Financial Impact – The amount of financial benefit received (e.g., revenue share, grants, subsidies).
3. Terms and Conditions – Any agreements, obligations, or restrictions tied to the economic interest.
4. Risks and Uncertainties – Any potential risks related to the financial dependency on the related organisation.
5. Funding Body Influence – If funding organisations impose conditions that affect decision-making.

Example:

A small agricultural SME receives interest-free loans from an NGO to promote sustainable farming. The agreement states that the SME must sell 30% of its produce to government-run stores at subsidised rates. Under IFRS for SMEs (2015), the SME must disclose this economic interest under Section 33, including:

- The nature of the relationship with the NGO.
- The loan amount and terms.
- Any restrictions or obligations imposed on the SME.

By complying with Sections 33 & 34, SMEs ensure stakeholders have a clear picture of external financial influences and dependencies.

9.3 Disclosure of Allocated Expenses

Under IFRS for SMEs, there must be transparency regarding how expenses are allocated, with sufficient detail in the financial statements or notes to ensure that stakeholders can understand the methodology.

The disclosure should include:

- The methodology used for allocation (e.g., square footage, time, revenue).
- A breakdown of which expenses were allocated and to which departments, projects, or segments.
- Any significant assumptions made during the allocation process.

9.3.1 Attribution and allocation of expenses

Attribution refers to assigning specific costs directly to a particular department, project, or segment based on direct causation. **Allocation**, on the other hand, refers to distributing indirect costs (such as overheads) among different departments or projects using a systematic and rational approach.

- i. **IFRS for SMEs** encourages entities to use allocation methods that are **rational and systematic**. For instance, if a company has shared facilities, it might allocate the costs of rent, utilities, and administrative services based on the size of the space used by each department or project.

Example:

A company allocates overhead expenses, such as rent, electricity, and office supplies, among its various departments (Sales, Production, and R&D) based on square footage. If the Sales department occupies 30% of the total office space, it would bear 30% of the overhead costs.

9.3.2 Disclosure of Allocated Expenses

Under IFRS for SMEs, there must be transparency regarding how expenses are allocated, with sufficient detail in the financial statements or notes to ensure that stakeholders can understand the methodology.

The disclosure should include:

- The methodology used for allocation (e.g., square footage, time, revenue).
- A breakdown of which expenses were allocated and to which departments, projects, or segments.
- Any significant assumptions made during the allocation process.

Example:

The financial statement's note might say:

- "Overhead costs of \$100,000 were allocated to departments based on square footage. The Sales department occupies 30%, and therefore, was allocated \$30,000 of overhead costs."

9.3.3 Attribution of expenses

Attribution of expenses focuses on how direct costs are assigned. In the case of a manufacturing company, direct costs like raw materials and labour might be attributed directly to the Production department.

Under IFRS for SMEs, expenses must be attributed in a way that reflects the actual usage or consumption of resources by each department or project.

Example:

- Raw materials costing \$50,000 are attributed directly to the Production department, as they are directly consumed in the production of goods.

9.3.4 Bases for Attribution

This section refers to the criteria or bases on which expenses are allocated. The base should reflect a fair and logical distribution of costs.

Examples of bases include:

- Revenue: If one department generates higher revenue, it may be allocated a higher share of overhead costs.
- Time: If employees spend a significant portion of their time on a project, that project might bear a proportionate share of indirect costs.
- Square footage: Allocating rent or utility costs based on the space each department uses.

Example:

A company allocates its administrative overhead (e.g., accounting, HR) based on the number of employees in each department. If the Sales department has 5 employees and the Production department has 10 employees, 33% of the overhead costs are allocated to Sales and 67% to Production.

Example in Context:

Company XYZ operates in both the Sales and Production sectors, with significant overhead costs shared across both. XYZ uses the following allocation methods:

- Attribution: Direct costs (raw materials and wages) are attributed directly to the Production department.
- Allocation: Overhead costs (rent, utilities, administrative costs) are allocated based on square footage.
- Bases for Attribution: Rent is allocated based on the square footage each department occupies (Sales occupies 30% of the total space, Production occupies 70%).

In their financial statements, XYZ would disclose:

1. Methodology: Overhead costs were allocated based on square footage.
2. Breakdown of allocated expenses: A note would detail the allocated rent and overhead costs for each department.
3. Attribution of direct expenses: Materials and wages are attributed directly to the Production department.

9.4 Contributions Receivable

Under IFRS for SMEs (2015), Contributions Receivable refers to contributions that are expected to be received by an entity, often from external sources such as donors, sponsors, or government grants. The treatment of such contributions varies depending on whether they are considered pledges, bequests, or other forms of contributions.

9.4.1 Recognition

Recognition of Contributions Receivable under IFRS for SMEs follows the principle that contributions should be recognized when there is a probable inflow of resources and the amount can be measured reliably. Contributions are typically recognized when they are committed (i.e., when the donor or grantor has made a pledge or agreement to provide resources).

Key conditions for recognition:

- Probable inflow: It must be probable that the entity will receive the contribution (i.e., the donor has made a firm commitment).
- Measurability: The amount of the contribution must be reliably measurable.
- Timing: The timing of recognition depends on the specific terms of the contribution.

Example:

XYZ Non-Profit receives a promise from a donor to contribute Rs. 500,000 for a specific project. The donation is unconditional, and the entity expects to receive the amount in the next 12 months. Since there is a probable inflow of resources and the amount is measurable, the entity recognizes the Rs.500,000 contribution in its financial statements.

9.4.2 Pledges and bequests

Pledges and bequests are types of contributions where the donor commits to giving a specific amount in the future, often without immediate payment.

- i. Pledges: These are promises by donors to provide contributions, which are generally recognisable as receivables when the commitment is made (i.e., when the promise is legally enforceable and measurable).
- ii. Bequests: These are contributions promised in a will or other testamentary document. Recognition may occur upon the probable realisation of the bequest, which is typically upon the death of the donor.
- iii. For both pledges and bequests:
- iv. If the contribution is conditional, it should be recognised only when the conditions are met.
- v. If the contribution is unconditional, it can be recognised immediately.
- i. **Example:** XYZ Foundation receives a pledge from a donor to contribute Rs. 200,000 over the next 5 years, starting from next year. Since the pledge is unconditional and the amount is measurable, XYZ recognizes the full Rs 200,000 as a receivable in its financial statements.
- ii. XYZ Non-Profit also receives a bequest of Rs. 50,000 in a will, contingent on the donor's death. The bequest is recognised when it becomes probable that the donor has passed away and the estate is likely to fulfil the contribution.

9.4.3 Disclosure

Under IFRS for SMEs, entities must disclose certain information about contributions receivable to provide transparency. The disclosure typically includes:

- i. The nature and terms of the contributions: Describing whether the contributions are unconditional or conditional and whether they involve any restrictions.
- ii. The amounts expected to be received: Detailing how much has been pledged or promised, and when it is expected to be received.
- iii. Any associated conditions: If there are conditions attached to the contributions (such as a specific project or performance requirement), these should be disclosed.
- iv. The timing of recognition: When the recognition will occur, and any uncertainties regarding timing.
- v. Risk of non-collection: If the entity expects a portion of contributions to be uncollectible, this should be disclosed, with an explanation.

Example:

- XYZ Charitable Trust discloses the following information in its financial statements:
 - "The Trust has received an unconditional pledge from Donor A for Rs. 500,000, to be received over the next 2 years. The amount is recognised as receivable."
 - "The Trust also has a bequest from the estate of Donor B, valued at Rs. 100,000, contingent on the donor's death. The bequest is not recognised in the current period but will be recognised when the event becomes probable."
 - "The Trust expects to collect 100% of the receivables, as the pledges are unconditional, and the donors have a history of fulfilling commitments."

9.5 Transition to the IFRS for SMEs

9.5.1 Scope of this section

- i. This section applies to a **first-time adopter of the IFRS for SMEs**, regardless of whether its previous accounting framework was **full IFRS** or another set of generally accepted accounting principles (GAAP), such as its national accounting standards or another framework such as the local income tax basis.
- ii. An entity that has applied the *IFRS for SMEs* in a previous **reporting period**, but whose most recent previous annual **financial statements** did not contain an explicit and unreserved statement of compliance with the IFRS for SMEs, must either apply this section or apply the *IFRS for SMEs* retrospectively by Section 10 Accounting Policies, Estimates and Errors as if the entity had never stopped applying the IFRS for SMEs. When such an entity does not elect to apply this section, it is still required to apply the disclosure requirements in paragraph

9.5.2 First-time adoption

- a. A first-time adopter of the IFRS for SMEs shall apply this section in its first financial statements that conform to this Standard.
- b. An entity's first financial statements that conform to this Standard are the first annual financial statements in which the entity makes an explicit and unreserved statement in those financial statements of compliance with the *IFRS for SMEs*. Financial statements prepared by this Standard are an entity's first such financial

statements if, for example, the entity:

- i. did not present financial statements for previous periods;
- ii. presented its most recent previous financial statements under national requirements that are not consistent with this Standard in all respects; or
- iii. presented its most recent previous financial statements in conformity with full IFRS.

c. Requires an entity to disclose, in a complete set of financial statements, comparative information in respect of the previous comparable period for all monetary amounts presented in the financial statements, as well as specified comparative narrative and descriptive information. An entity may present comparative information in respect of more than one comparable prior period. Consequently, an entity's date of transition to the IFRS for SMEs is the beginning of the earliest period for which the entity presents full comparative information by this Standard in its first financial statements that conform to this Standard

9.5.3 Procedures for preparing financial statements at the date of transition

- i. An entity shall on its date of transition to the IFRS for SMEs (ie the beginning of the earliest period presented):
 - ii. recognise all **assets** and **liabilities** whose **recognition** is required by the IFRS for SMEs;
 - iii. not recognise items as assets or liabilities if this Standard does not permit such recognition;
 - iv. reclassify items that it recognised under its previous financial reporting framework as one type of asset, liability, or component of **equity**, but are a different type of asset, liability, or component of equity under this Standard; and
 - v. Apply this Standard in measuring all recognised assets and liabilities.
- vi. The **accounting policies** that an entity uses on adoption of this Standard may differ from those that it used for the same date using its previous financial reporting framework. The resulting adjustments arise from transactions, other events, or conditions before the date of transition to this Standard. Consequently, an entity shall recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity) at the date of transition to this Standard.
- vii. On first-time adoption of this Standard, an entity shall not retrospectively change the accounting that it followed under its previous financial reporting framework for any of the following transactions:
 - a. **derecognition of financial assets and financial liabilities.** Financial assets and liabilities derecognised under an entity's previous accounting framework before the date of transition shall not be recognised upon adoption of the IFRS for SMEs. Conversely, for financial assets and liabilities that would have been derecognized under the IFRS for SMEs in a transaction that took place before the date of transition, but that were not derecognized under an entity's previous accounting framework, an entity may choose (a) to derecognize them on the adoption of the IFRS for SMEs or (b) to continue to recognize them until disposed of or settled.

- b. Hedge accounting. An entity shall not change its hedge accounting before the date of transition to the IFRS for SMEs for hedging relationships that no longer exist at the date of transition. For hedging relationships that exist at the date of transition, the entity shall follow the hedge accounting requirements of Section 12 *Other Financial Instrument Issues*, including the requirements for discontinuing hedge accounting for hedging relationships that do not meet the conditions.
- i. **equipment**, an **investment property**, or an **intangible asset** on the date of transition to this Standard at its fair value and use that fair value as its deemed cost at that date.
- ii. Revaluation as deemed cost. A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment, an investment property, or an intangible asset at, or before, the date of transition to this Standard as its deemed cost at the revaluation date.
- iii. (da) event-driven fair value **measurement** as deemed cost. A first-time adopter may have established a deemed cost following its previous GAAP for some or all of its assets and liabilities by measuring them at their fair value at one particular date because of an event, for example, a valuation of the business, or parts of the business, for a planned sale. If the measurement date:

9.5.4 Disclosures

9.5.4.1 Explanation of transition to the IFRS for SMEs

- a. An entity shall explain how the transition from its previous financial reporting framework to this Standard affected its reported **financial position**, **financial performance**, and **cash flows**.
- b. An entity that has applied the IFRS for SMEs in a previous period, as described in paragraph 9.5.1-ii, shall disclose:
 - ii. The reason it stopped applying the IFRS for SMEs.
 - iii. the reason it is resuming the application of the IFRS for SMEs; and
 - iv. Whether it has applied this section or has applied the *IFRS* for SMEs retrospectively.

9.5.4.2 Reconciliations

- i. An entity's first financial statements prepared using this Standard shall include:
 - (a) a description of the nature of each change in accounting policy;
 - (b) Reconciliations of its equity determined by its previous financial reporting framework to its equity determined by this Standard for both of the following dates:
 - (i) the date of transition to this Standard; and
 - (ii) the end of the latest period presented in the entity's most recent annual financial statements, determined by its previous financial reporting framework.
 - (c) a reconciliation of the profit or loss determined by its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined by this Standard for the same period.
- ii. If an entity becomes aware of **errors** made under its previous financial reporting framework, the reconciliations required to the extent practicable, distinguish the correction of those errors from changes in accounting policies.
- iii. If an entity did not present financial statements for previous periods, it shall disclose that fact in its first financial statements that conform to this Standard.

Summary

This unit covers various financial aspects, including provisions, collections, economic interest, and expense allocation. It explains provisions as liabilities with uncertain timing or amount and discusses collections in terms of receivables and revenue recognition. Economic interest and relationships with funding bodies highlight financial dependencies and disclosure requirements. The unit also focuses on expense attribution, ensuring transparency in financial reporting. Contributions receivable, including pledges and bequests, are analysed under IFRS for SMEs. Lastly, the transition to IFRS for SMEs is discussed, covering first-time adoption and required disclosures.

References:

<https://www.ifrs.org/projects/completed-projects/2015/2015-comprehensive-review-of-the-ifrs-for-smes/>

Book: International Financial Reporting Standard for SMEs 2015