Ten ways to make sure financial statements are not misstated

Gary Stevenson explains some of the common pitfalls facing professionals when it comes to fulfilling increasingly complex requirements

Preparing financial statements can be challenging these days, owing to the growing complexity of accounting standards. Being aware of some of the issues that could trip you up should make things a little easier.

1. Transactions with owners: income or capital?

Income and expenses exclude contributions from or distributions to owners. Instead, such transactions are recognized in equity. An owner may also enter into transactions with the entity in another capacity, for example, as a lender, a supplier or a customer. The substance of these transactions should be carefully considered to determine whether they include an element of an equity transaction.

Example

An entity transfers a loan receivable to a shareholder at consideration equal to the outstanding principal amount. There is objective evidence that the loan was impaired at the date of transfer. Any consideration received in excess of the fair value of the loan represents a capital contribution and should be recognized in equity.

2. Business combinations: determining the acquisition date

The acquisition date is the date that the acquirer obtains control of an acquiree. The purchase agreement may state that the acquisition is effective on a specified date. However, the date on which control is obtained will be a matter of fact.

Example

Entity A completes the acquisition of entity B on 28 February. A appoints directors to replace the existing board of B on that date. The acquisition agreement states the acquisition is effective from 1 January and all profits earned after that date will go to A. The purchase price is determined based on the net asset position of B at 31 December 2012. A will consolidate B from 28 February as this is the date from which A obtains control of B.

3. Fair value and impairment losses

Where the fair value less costs to sell of an individual asset is less than its carrying amount, an impairment loss is not automatically recognized. It is also necessary to consider whether the asset's value in use can be determined. If the entity plans to sell the asset in the near future, then cash flows from its continuing use may be negligible and the asset's value in use will approximate its net disposal proceeds. In most other cases it will not be possible to estimate the value in use of a single asset as the asset will not generate cash inflows independently of other assets or groups of assets. Instead, the recoverable amount of the cash-generating unit to which the asset belongs will be tested for impairment. No impairment loss will be recognized for the asset if the related cash-generating unit is not impaired notwithstanding that the asset's fair value costs to sell is less than its carrying amount.

Example

An entity considers that the carrying amount of its technical know-how and patents may be impaired due to a decline in sales of related products. It determines that their fair value less costs to sell is less than their respective carrying amounts based on a professional valuation report.

The entity will also need to determine the recoverable amount of the cash-generating unit to which the technical know-how and patents belong as these assets do not generate independent cash inflows. Any cash-generating unit impairment loss allocated to the assets should not reduce their carrying amounts below their fair value less costs to sell. If the cash-generating unit is not impaired no impairment loss will be recognized for the assets.

However, it may be necessary to reassess the period and method of amortization to better reflect their remaining useful life and the pattern of consumption of their economic benefits by the entity.

4. Impairment: selecting a discount rate

Projected cash flows are discounted at a pre-tax rate that reflects the risks specific to the asset or cash-generating unit being tested for impairment when calculating value in use. The entity's weighted average cost of capital will often provide an appropriate starting point when selecting a discount rate. Using a single entity level discount rate will not be appropriate however where the entity has multiple cash-generating units that are subject to different business risks. Adjustments to the entity's weighted average cost of capital will be necessary in this situation to estimate an appropriate discount rate for each cash-generating unit.

Example

An entity operates property development, investment and consultancy businesses. Each business is identified as a separate cash-generating unit for impairment testing. Historically, the growth rates and financial performance of each of the cash-generating units has varied significantly from one another. The property investment and consultancy businesses are focused on the Hong Kong market

while the property development business operates in the Mainland. The entity uses its weighted average cost of capital when calculating the value in use of each cash-generating unit.

The entity's weighted average cost of capital should be adjusted to reflect the unique risk factors of each cash-generating unit. Although all the cash-generating units operate in the property sector, they each provide different products or services and generate different returns. In addition, the property development cash-generating unit operates in a different economic environment and generates cash flows in a different currency.

5. General borrowing costs: when to capitalize?

Borrowing costs to be capitalized are those that would have been avoided if the expenditure on the qualifying asset had not been made. General borrowings are all borrowings except those used specifically to finance qualifying assets. Where qualifying assets are funded out of general borrowings, the amount of borrowing costs to be capitalized is calculated by applying a capitalization rate to the expenditures on the asset.

Example

An entity has taken out loans for working capital purposes and for a business acquisition. It constructs a production plant which is considered a qualifying asset. The plant is partly funded by a new loan and partly out of operating cash flows. The entity has capitalized the borrowing costs of the new loan.

The working capital and acquisition loans are general borrowings as neither was used to finance a qualifying asset. The cash used to fund the production plant could have been used to repay the general borrowings. The interest costs on those borrowings could therefore have been avoided had the plant not been built. The entity should capitalize part of the general borrowing costs.

6. Share-based payment: cancellation or forfeiture of awards?

If a service condition or a non-market performance condition is not met, an award will be considered forfeited. This might occur, for example, if the employee resigns or the company fails to complete an initial public offering. No expense is recognized where an unvested award is forfeited. If an unvested award is cancelled, other than as a result of forfeiture, this is treated as an acceleration of vesting. The entity recognizes immediately the amount that would otherwise have been recognized over the remaining vesting period.

Where an unvested award is cancelled it is therefore necessary to determine whether this is a consequence of forfeiture or not.

Example
A director of company X voluntarily cancels unvested share options.

This cancellation is accounted for as an accelerated vesting and not as a forfeiture even though it was at the choice of the director as it does not result from failure to meet a vesting condition.

7. Convertible notes: anti-dilution clauses

Conversion rights, which result in the exchange of a fixed amount of cash for a fixed number of shares, are classified as equity. If this test is not met they are accounted for as a derivative financial liability. Convertible notes may include anti-dilution clauses to protect the note holder when one or more dilutive events occur, for example, bonus issues, share splits or rights issues.

Although such clauses result in a variable number of shares being issued, they are not considered to fail the fixed-for-fixed test provided the effect is to maintain the relative rights of the note holders and equity shareholders before and after the dilutive event. The terms of anti-dilution clauses need to be considered carefully therefore to determine the substance of any adjustments.

Example
An entity issues a convertible note with a conversion price of HK$1. The note contains an anti-dilution clause which resets the conversion price to the lower of HK$1 and the price of any new shares which are issued at full market value.

This adjustment fails the fixed-for-fixed test as it compensates the note holders if new shares are issued at a market price which is lower than the conversion price. Other equity shareholders do not enjoy a similar benefit.

8. Current liabilities: classification of convertible notes

Where a convertible note is accounted for as a compound financial instrument the debt and equity components are presented separately. The debt component is classified as a current or non-current liability depending on the terms of the note. Any terms that could, at the option of the counterparty, result in settlement of the note by the issue of equity instruments do not affect this classification.

The possibility of conversion is ignored therefore and only the repayment terms of the debt component are considered. Convertible notes may often contain embedded put options. Irrespective of whether these embedded derivatives are accounted for separately or as part of the debt component they are always relevant to the current or non-current classification of the note.

Example
Entity Y issued a five-year convertible note on 1 March 2011, which is accounted for as a compound financial instrument. The note is convertible into ordinary shares at the option of the holder at any time after issue. The terms also include an embedded put option, exercisable by the holder from the second anniversary of the date of issue of the note. The option has been accounted for separately as a derivative financial liability.

Entity Y classifies the debt component of the note as non-current in its financial statements for the year ended 31 December 2011. The fact that the note can be settled by issuing shares within 12 months does not affect this classification. Entity Y will however classify the debt component as a current liability in the following financial year as it cannot avoid the obligation to settle the note in cash within 12 months if the holder exercises the put option.

9. Financial instruments: dealing in commodities

Contracts to buy and sell non-financial items such as commodities are accounted for as derivatives where the contracts can be settled net in cash unless they are entered into and continue to be held for the entity's own use. One of the ways a contract will be considered to be settled net in cash is where the entity has a past practice of taking delivery of the commodity and selling it within a short period after delivery for the purpose of generating profit from short-term fluctuations in price or dealer's margin. The own use exemption does not apply to these contracts. Consequently entities that are dealing or trading in commodities will normally have to account for their purchase and sale contracts as derivatives.

Example
Entity Z buys and sells nonferrous metals, such as copper and aluminium, to generate a dealing profit. Z sells the metals within a short period after delivery in the same condition that they were purchased from Z's suppliers. Z provides no services related to the metals to customers.

Entity Z's commodity sales and purchase contracts are considered to be net cash settled and will be accounted for as derivative financial instruments.

10. Service contracts: recognition of costs

Revenue and costs that relate to the same transaction or event are normally recognized together. For some service contracts the timing of incurring costs may vary considerably from the timing of recognizing revenues. Costs should only be deferred however when they qualify for recognition as an asset.

Example
Entity C provides environmental project development and advisory services to customers to assist them in reducing their carbon emissions. Each service contract normally lasts for five years. The amount of consideration is based on the annual emissions allowances obtained by the customer during the contract period. Revenue is recognized when the emissions allowances are certified each year. C incurs significant non-recurring set-up costs, including staff costs, professional fees and travel expenses in the first year of the contract. There are few such costs in later years.

The one-off set-up costs will be expensed as incurred, as they do not meet the definition of inventory, property, plant and equipment or intangible assets. Spreading these costs over the contract period would not be appropriate.

Gary Stevenson is director, technical and training, at BDO Hong Kong.