CIPFA The Chartered Institute of Public Finance & Accountancy

ROUTLEDGE

International Public Financial Management

Essentials of Public Sector Accounting

Gary Bandy

International Public Financial Management

Running public sector organizations requires specialist accounting and finance skills to overcome the unique challenges of the sector. Citizens rely on their governments to provide a wide range of public services from an inevitably limited budget and therefore the better that the public money is managed the more services that can be delivered. Just as there is no single best way to manage a business, there is no single best way to manage public finances.

Co-published by the Chartered Institute of Public Finance and Accountancy (CIPFA), the world's leading professional public finance accountancy body, *International Public Financial Management: Essentials of Public Sector Accounting* provides an expert introduction to public sector accounting and finance. This book was conceived to accompany CIPFA's International Public Financial Management (IPFM) qualifications as a resource for students that seeks to capture the essential elements of the modules they study, and reflects good practice as put forward by CIPFA in its examination syllabuses.

Students of public management and public sector accounting will find this a useful text. Practitioners working in the public sector will also find this concise book vital reading in seeking value for money in providing public services.

Gary Bandy CPFA is a public financial management expert who helps public bodies to get the best value for money from their limited resources. He is also an accomplished lecturer, teaching on Master's courses at leading business schools.

'This magnificent handbook is essential not only for financial managers but for anyone trying to improve their organisation's performance in these volatile and uncertain times. Gary writes clearly, coherently and concisely – and the fact that he practises what he teaches (in several countries including South Sudan) gives this book real practical clout.'

Emeritus Professor John Benington CBE, University of Warwick Business School, UK, Chair of Trustees, Friends of Ibba Girls School, South Sudan

'This book provides students and practitioners with a clear exposition of core concepts and an accessible explanation of key issues in the governance, accounting and financial reporting of public sector organisations in an international perspective.'

Dr Alberto Asquer, School of Finance and Management, SOAS University of London, UK

'In this book Gary Bandy has provided an excellent introduction to the fundamentals of International Public Financial Management. It will therefore prove an invaluable guide for students, practitioners and policy makers.'

Laurence Ferry PhD (Warwick), FCPFA, BA (Hons), SFHEA, PCAPL, Professor in Accounting at Durham University, UK

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Essentials of Public Sector Accounting

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Foreword

At the heart of a well-run government is its public financial management system. The quality of that system is a key determinant of the well-being and living standards of its citizens. It is also a key determinant of the trust citizens have in their government. Ultimately it can either protect or erode individual freedom. Patrick Henry, the American revolutionary leader, said: *The liberties of a people never were, nor will ever be, secure, when the transactions of their rulers may be concealed from them*. The PFM system is the means by which the people are informed of, or have concealed from them, the transactions of their government. It is that important. And the PFM system also has symbolic importance, signifying whether or not the government has the most basic level of managerial competence – Can it produce a budget before the start of a financial year? Can it produce timely financial statements which receive an unqualified audit opinion? Does the budget reflect the matters of strategic importance the government is addressing?

The well-being of the citizens of any country is vitally affected by the actions taken by their government, whether those actions involve taxation and the transfer of resources between citizens, the production of services, whether in law and order, health, education, the regulation of individual and corporate behaviour, or the acquisition or disposal of assets. The PFM system is key to ensuring that decisions made in all these areas add value for existing citizens and protect the rights of future citizens.

Regrettably, in many countries, PFM systems do not function as they should. Key decisions are made using incomplete, inaccurate, and irrelevant information. The results can be catastrophic for the economy and society, as has been seen in Greece in recent years. In the period since the global financial crisis the financial position of many major governments has worsened alarmingly, reducing their ability to withstand economic or other shocks.

If PFM systems are important, they need to be well managed. This book provides information that will prepare people to be those managers, support those who already are, and inform those who wish to understand better the way governments can, do, or should function.

Ian Ball
Professor of Public Financial Management,
Victoria University of Wellington
Chairman Emeritus, CIPFA International

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Chartered Institute of Public Finance and Accountancy (CIPFA)

CIPFA is the only professional accountancy body in the world exclusively dedicated to public finance. Our members work throughout the public services, in bodies where public money needs to be effectively and efficiently managed.

As the world's only professional accountancy body to specialise in public services, CIPFA's portfolio of qualifications are the foundation for a career in public finance. They include the benchmark professional qualification for public sector accountants as well as a postgraduate diploma for people already working in leadership positions.

The content for this book is sourced from CIPFA's International Public Financial Management (IPFM) course material. For information on studying for a CIPFA qualification visit www.cipfa.org/qualifications/ipfm.

About the author

Gary Bandy has been a member of the Chartered Institute of Public Finance and Accountancy since 1990. Until 2005 his career was mostly in local government finance, but he spent two years as a public sector auditor in a Big 4 firm. This period also included three years as the chief finance officer of a city government with annual spending of more than £600m.

Since becoming an independent public financial management consultant in 2005, he has advised organizations in the charity sector, education, policing, local government, and the private sector and shared his knowledge and experience as a teacher on postgraduate courses. He has also created an open, online course about managing public money for the Open University and CIPFA.

His first book, *Financial Management and Accounting in the Public Sector*, was well-received and one reviewer said: 'If you really want to understand the new world of public sector finance sit down with this text and all will be revealed.'

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Abbreviations

ABC	activity-based costing
BCR	benefit-cost ratio
CBA	cost-benefit analysis
CIPFA	Chartered Institute of Public Finance and Accountancy
DEL	departmental expenditure limit
EU	European Union
GAAP	generally accepted accounting practice
GDP	gross domestic product
IASB	International Accounting Standards Board
IAASB	International Auditing and Assurance Standards Board
ICT	information and communications technology
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard
IIA	Institute of Internal Auditors
IPSAS	International Public Sector Accounting Standard
IPSASB	International Public Sector Accounting Standards Board
IRR	internal rate of return
ISA	International Standard on Auditing
MTEF	medium-term expenditure framework
MTFS	medium-term financial strategy
NAO	National Audit Office
NDPB	non-departmental public body
NPM	new public management
NPV	net present value
OECD	Organization for Economic Cooperation and Development
PEFA	public expenditure and financial accountability
PFI	private finance initiative
PFM	public financial management
PPP	public-private partnership
SORP	statement of recommended practice
TME	total managed expenditure
VAT	value added tax
WGA	whole of government accounts
ZBB	zero-based budgeting

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1 Introduction

Christine Lagarde, the managing director of the International Monetary Fund, wrote: 'Public financial management – the fine art of budgeting, spending, and managing public monies' (Lagarde, 2013). It is important that public money is well-managed because citizens rely on their governments to provide a wide range of public services from an inevitably limited budget. The better that the public money is managed, the more services that can be delivered.

Public managers in government ministries, schools, libraries, hospitals, etc., have different specific goals and objectives from each other, but they share the need to spend public money to achieve their goals. This is different from the private sector. Managers in many (but not all) companies are spending other people's money and they are expected to do so in a way that increases shareholder value (in short, they are spending money to make more money).

The objectives of public financial management (PFM) for a government or any other public organization are:

- to maintain a sustainable financial position
- to allocate resources effectively to sectors, ministries, departments, projects, and programmes
- to provide public goods and services efficiently.

There is no single best way to manage public finances, just as there is no single best way to govern a country or manage a business. This book, however, reflects good practice as put forward by the Chartered Institute of Public Finance and Accountancy (CIPFA – the only professional accounting body in the world which specializes in public sector accounting and financial management) in its examination syllabuses.

This book was conceived to accompany CIPFA's International Public Financial Management (IPFM) qualifications as a resource for students. Those students receive between four and ten workbooks for each module of the qualification. There is a massive amount of information in the workbooks (naturally) along with quizzes and test exam questions. This book is not a substitute for the module workbooks: instead it is intended to be a complementary book

that seeks to capture the essential elements of the modules. (For more information about the IPFM qualifications, see www.cipfa.org/qualifications/ipfm.)

This book will be useful to readers who are not studying the IPFM qualification but are thinking about it because it can give them some insight into what would be involved and what they would be expected to learn.

The book also has something to offer to readers who are interested in the subject of managing public money even if they do not intend to take the IPFM qualifications. These might be politicians, managers, or accountants working in the public sector anywhere in the world who will find the book useful because it encapsulates the important concepts of public financial management and will help them to improve the value for money of the public services in which they are involved.

Structure of this book and how it links to the CIPFA qualifications

There are 12 modules in CIPFA's IPFM qualification and passing the assessment for all of them results in the full professional qualification and the right to use the CPFA designation. The IPFM qualification is structured, however, so that passing some of the modules can result in the award of a certificate, diploma, or advanced diploma. Table 1.1 is an overview of the modules in each level of the qualification and includes a reference to the relevant chapter in this book for each module.

The chapters in this book are not ordered exactly in line with the progression suggested by Table 1.1. Whilst the book can be read from front to back, the chapters are independent of each other so it is possible to choose your own order for reading them.

Contents

The first two chapters are the certificate-level modules because they are the foundation of the remainder of the qualification. Chapter 2 is about **financial accounting**, which are the aspects of accounting that focus on bookkeeping, control of systems, and producing financial statements for external users. The chapter describes the principles and main activities of financial accounting, but it does not go into depth on how to do bookkeeping or reconciliations: that level of detail would require a whole textbook on its own.

Chapter 3 turns to **management accounting** which is the provision of useful information to aid management in decision-making, planning, control, and problem solving. A management accountant therefore has an internal focus rather than the external focus of financial accountant. The chapter covers some of the main things with which a management accountant would be concerned, namely costing (which is concerned with how much it costs a business produce goods or services and how much profit is generated from selling them), budgeting (including alternative methods for creating budgets), and budgetary control.

Table 1.1 CIPFA's IPFM qualifications

Certificate in International Public Financial Management	*Diploma in International Public Financial Management*	*Advanced Diploma in International Public Financial Management*	*Professional Qualification (i.e. full CPFA professional status)*
Financial Accounting Chapter 1 Accounting concepts double-entry bookkeeping ethics preparing financial statements **Management Accounting** Chapter 2 Costs and cost behaviour budgeting control decision-making	**Public Sector Financial Reporting** Chapter 8 Reporting frameworks financial statements interpretation of financial statements whole of government accounts **Audit and Assurance** Chapter 12 Audit environment risk assessment audit testing internal audit **Financial Management** Chapter 4 Sources of finance treasury management risk management pricing working capital management **Business and Change Management** Chapter 5 Managing projects managing programmes managing change commissioning and procurement	**Company Financial Reporting** Chapter 7 Financial reporting frameworks single entity financial statements consolidated financial statements analysis of financial statements **Public Finance** Chapter 6 Public expenditure and revenue managing the economy public borrowing and debt taxation **Strategy and Policy Development** Chapter 9 Strategy and policy development framework stakeholders evaluating strategies configuring an organization **Governance, Public Policy and Ethics** Chapter 11 Governance ethics policy-making processes transnational policy making	**Strategic Public Finance** Chapter 10 Sources of finance for public sector organizations financial planning delivering public services **Strategic Case Study** All chapters

Financial management is the process of acquiring and using finance and it is the subject of Chapter 4. The chapter includes some basics of business finance such as sources of finance and the cost of capital which have some relevance to public sector organizations, too. The chapter also explains some techniques to appraise investment opportunities and the basics of risk management before tackling pricing. This is a subject of prime importance to a business, but there

are many parts of the public sector where prices are charged so it has some relevance to public managers. The chapter also covers working capital management and treasury management.

Finance managers exist within an organization and they have a role to play in the change projects that happen in the organization. Chapter 5 therefore looks at the common features of **business change management,** including the general issues relating to justifying the investment of resources in a change project and key aspects of leading change. The chapter also has sections about project management and programme management. The final section is about commissioning change, and it covers the many ways that public sector organizations commission third parties to deliver services to citizens on their behalf.

Chapter 6 is about **public finance**. In particular it is about where the money comes from to pay for public services: such as taxation or from government borrowing.

Chapter 7 builds on Chapter 2 by looking at **company financial reporting**, which is the main product produced by financial accountants. The accounting standards that apply to public sector organizations like government ministries, hospitals, and local councils are based on the accounting standards used by companies. There is a lot of similarity, therefore, between the financial statements of a company and of a public sector organization. They are not the same, though, and Chapter 8 on **public sector financial reporting** explains the reasons for the differences and illustrates it with examples from the UK.

Chapter 9 is similar to Chapter 5 insofar as it is about a non-financial subject for which effective financial managers need a solid understanding. They need to understand **strategy and policy development** if they are to be able to give relevant advice to the senior managers and the governing body of their organization (whether a board of directors or elected officials). This chapter explains some of the key terms relating to strategy and policy and also introduces a wide variety of tools and techniques that can be used by managers to develop and analyse policies. An organization's strategic approach to achieving its mission can also influence how the organization is structured, so there is a section about a range of different ways an organization can be designed and structured.

Chapter 10 is about **strategic public finance**. It looks in a strategic way at some of the activities and issues covered in earlier chapters. These include government borrowing (building on treasury management from Chapter 4), the balance of funding between grants and local taxation (an extension of Chapter 6) and public-private partnerships (building on from the commissioning section in Chapter 5). There is also a section on international development aid, an important source of finance for the public sector in many countries.

Governance, public policy, and ethics are important to all public finance managers, and this is the subject of Chapter 11. The governance part looks at how the UK's public sector is structured at the macro level as well as considering corporate governance at the micro level of the organization. There is also a section on international policy making which covers issues like globalization.

The final chapter focuses on **audit and assurance**. The chapter is mostly about the role and responsibilities of external auditors (the provision of assurance about an organization's published financial statements), but it includes a section about internal audit. The section about how to carry out an audit (e.g. audit planning and the types of test an auditor can do) is equally applicable to internal and external auditors.

2 Financial accounting

Summary

Financial accounting comprises the aspects of accounting that focus on bookkeeping, control of systems, and producing statements of accounts for external users. Financial accountants are involved in recording, classifying, and summarizing transactions and then communicating financial information about the organization. The organization's owners and management are the principal audience for the financial information, but there are other interested parties including customers, suppliers, potential investors, business analysts, and government agencies.

Financial accounting is distinct from management accounting. The latter has more of an internal focus and is described in Chapter 3. In larger organizations the financial and management accounting might be done by separate teams, but in small organizations an accountant might be involved in both types of accounting.

This chapter describes the principles and main activities of financial accounting. It does not go into depth on how to do bookkeeping or reconciliations: that level of detail would require a whole textbook on its own.

Key terms used in this chapter

Accounting standards are published principles for preparing financial statements that ensure comparability. There are alternative sets of accounting standards adopted by different countries, and some of those will be explored in this chapter and later in this book.

Accrual accounting is a system which recognizes income and expenditure in the period they are earned or incurred rather than when payments are received or made.

Accruals are the adjustments made at the end of each accounting period to convert receipts into income and payments into expenditure.

An **adjusting event** is an event that occurred *between* the reporting date and the date when the financial statements are authorized (signed) which must be reflected in the financial statements, normally without any disclosure in the notes to the accounts.

A **balance sheet** is a statement of the assets, liabilities, and reserves of an organization at a particular point in time. For every organization the assets are always equal to the sum of liabilities and capital. A balance sheet may also be called a **statement of financial position**.

Cash equivalents are short-term, highly liquid investments that are readily converted to known amounts of cash and which have insignificant risk of changes in value.

Cash flow is the receipt and payment of money. A **cash flow statement** analyses the cash flow for an accounting period into the sources of cash and its use by the organization.

Double-entry bookkeeping is a system of bookkeeping where each transaction is entered as a debit and a credit thus keeping the total system balanced to zero.

Fraud is the intentional distortion of financial statements or other records by persons internal or external to the organization which is carried out to conceal the misappropriation of assets or otherwise for gain.

An **income statement** is a statement in which revenues and expenditure are matched to arrive at a figure of profit or loss for the accounting period (in the public sector the result is the surplus or deficit for the accounting period).

International Accounting Standards Board (IASB) is an independent standard-setting board which aims to 'provide the world's integrating capital markets with a common language for financial reporting by setting accounting and financial reporting standards'. It is responsible for issuing **International Financial Reporting Standards (IFRS)** and updating the **International Accounting Standards (IAS)** which preceded the IFRS.

A **liability** is an obligation of an entity to transfer economic benefits as a result of past transactions or events.

A **non-adjusting event** is an event that occurred between the reporting date and the date when the financial statements are authorized (signed) which must not be reflected in the financial statements, but if it is a material event it should be disclosed in a note.

Property, plant, and equipment (PPE) are tangible assets that are held for use for more than one accounting period for the production or supply of goods or services, for rental to others, or for administrative purposes.

A **provision** is a liability of uncertain timing or amount.

Recoverable amount is the higher of the fair value less selling costs (net realizable value) and the value in use.

2.1 What is financial accounting?

Accounting is the recording of business transactions in monetary terms. Financial accounting involves recording, classifying, summarizing, and communicating financial information.

Financial accounting is just one of many accounting specialisms. Financial accounting is focused on producing external reports for users in the form of

financial statements. These statements are aimed primarily at outsiders and are not usually for management use. Another accounting specialism, management accounting, is concerned with producing information for internal use by managers and that is the subject of Chapter 3.

Financial statements are produced by businesses to satisfy the requirements of external users. The statements will be used for many decisions/reasons including:

- to buy, hold, or sell equity investments
- assessment of stewardship and accountability
- assessment of the entity's ability to pay employees and creditors
- assessment of the security of loans
- determination of taxation policies
- determination of distributable profits and dividends
- inclusion in governmental statistics
- regulations of the corporate activities.

Many of the preceding, but not all, apply to users of the financial statements prepared by public sector bodies.

There are a number of key concepts in accounting practice. The main ones are listed as follows.

- **Going concern:** when preparing financial statements the standard assumption is that the business will continue to operate for the foreseeable future. If that is not the case, the judgements made by the accountant would be different.
- **Accruals/matching:** revenue earned must be matched with the expenditure incurred in earning it into the relevant period.
- **Prudence:** the application of caution by ensuring that assets and income are not overstated, and that liabilities and expenses are not understated.
- **Consistency:** judgements used in the preparation of financial statements are applied consistently from one accounting period to another.
- **Money measurement:** financial information only takes into account those items that can be stated in monetary terms.
- **Separate determination:** potential liabilities and assets should be shown separately and not netted against each other.
- **Materiality:** only items material in amount or in their nature will affect the true and fair view given by a set of accounts.
- **Historical cost convention:** transactions are normally recorded at their original cost (the amount actually paid) and, where materially different from the historical cost, adjustments are made to reflect the current value of assets and liabilities.
- **Substance over form:** financial statements should reflect the commercial substance of a transaction rather than the legal form of the transaction (although most of the time the substance and form are the same).

- **Stable monetary unit:** the value of the unit in which accounting statements are prepared does not change.
- **Objectivity or neutrality:** accountants should not include personal opinion or prejudice when preparing financial statements.
- **Realization:** revenue and profits are recognized in the financial statements when realized.
- **True and fair view:** financial statements should give a true and fair view of the business.

The main accounting statements

The main accounting statements for any organization are a statement of financial position and an income statement. The statement of financial position shows a summary of the financial position of an organization on a particular date. It tells the reader what assets the organization owns or controls, what liabilities the organization owes to others and where the organization obtained its financial resources (capital). For any organization its total assets equals the sum of its capital and its liabilities.

A simple **statement of financial position** is shown in Figure 2.1. In the figure, non-current assets are assets that are expected to benefit the business for more than one accounting period (usually a calendar year), such as property, plant, and equipment; whilst current assets are assets like cash and inventory which are expected to be consumed within a single accounting period. Likewise, current liabilities are the liabilities which are payable within the upcoming accounting period, and non-current liabilities are payable further into the future.

The **income statement** is a statement in which revenues and expenditure are matched to arrive at a figure of profit or loss for the accounting period. A simple

Statement of financial position as at XX.XX.XXXX	£
Non-current assets	X
Current assets	X
Total assets	**X**
Capital	X
Non-current liabilities	X
Current liabilities	X
Total capital & liabilities	**X**

Figure 2.1 A statement of financial position

Income statement for the year ended XX.XX.XXXX	**£**
Sales revenue	X
Less: Cost of sales/cost of goods sold	(X)
Gross profit	X
Less expenses (detailed)	(X)
Net profit	**X**

Figure 2.2 An income statement

income statement is shown at Figure 2.2. Revenue is the value (usually the selling price) of goods or services transferred to customers during the period. The cost of sales/cost of goods sold is the cost of producing and/or purchasing all goods and services sold to customer in the period. These are direct costs. Expenses are the indirect costs incurred in generating revenue during the period and would include overhead items like management and support services.

Any entity which prepares financial statements in accordance with IAS is obliged (under IAS 7) also to prepare a **statement of cash flows**. This is a statement which summarizes the inflows and outflows of cash and cash equivalents (short-term, highly liquid investments that are readily converted to known amounts of cash) between two dates.

Figure 2.3 is an example of a statement of cash flows. The statement is broken down into three sections:

- cash flows from operating activities (which are the principal revenue producing activities and other activities that are not investing or financing activities)
- cash flows from investing activities (which are the acquisition and disposal of non-current assets and other investments not included in cash equivalents)
- cash flows from financing activities (which are activities that result in changes in the size and composition of the equity capital and borrowings).

The sum of the previous sections will equal the net increase/decrease in cash and cash equivalents over the period. It can be helpful if the statement of cash flows is prepared using the indirect method, which is a method which starts with the net profit (or loss) for the period and then makes adjustments to remove accruals and non-cash transactions to establish the cash generated from operations over the period. This method makes it clear how the statement of cash flows relates to the income and expenditure statement as well as the statement of financial position.

Statement of cash flows for . . . the year ended . . .		
	£	£
Cash flows from operating activities		
Net profit before taxation	X	
Adjust for:		
Depreciation	X	
(Profit)/loss on disposal of non-current assets	(X)/X	
Investment income (as per income statement)	(X)	
Interest expenses (as per income statement)	X	
Operating profit before working capital changes		
(Increase) decrease in inventories	(X)/X	
(Increase) decrease in trade receivables	(X)/X	
(Increase) decrease in prepayments	(X)/X	
Increase (decrease) in trade payables	X/(X)	
Increase (decrease) in accruals	X/(X)	
Cash generated from operations		X/(X)
Interest paid	(X)	
Tax paid	(X)	
Net cash flow from operating activities		X/(X)
Cash flows from investing activities		
Purchase of non-current assets	(X)	
Proceeds on the sale of non-current assets	X	
Interest received	X	
Dividends received	X	
Net cash flow from investing activities		X/(X)
Cash flows from financing activities		
Issue of new capital	X	
Redemption of capital	(X)	
Raising of loans	X	
Redemption of loans	(X)	
Dividends paid	(X)	
Net cash flow from financing activities		X/(X)
Net increase in cash and cash equivalents		**X/(X)**
Cash and cash equivalents at beginning of period		**X/(X)**
Cash and cash equivalents at end of period		**X/(X)**

Figure 2.3 A statement of cash flows

One of the uses of a statement of cash flows, therefore, is to explain the changes in a statement of financial position from one reporting date to the next. A statement of cash flows can be important to stakeholders of an organization because business survival has more to do with generating cash than profits. That is, a business can be profitable by selling goods on credit but if customers do not pay, sooner or later the business will be in difficulty.

Accounting practice and accounting standards

Generally accepted accounting practice (GAAP) refers to the complete set of accounting regulations from all sources which apply in a given jurisdiction, together with any general accounting principles or conventions that are usually applied in that jurisdiction. GAAP therefore includes accounting legislation, accounting standards, and accounting concepts or conventions in a particular context. This means, for instance that GAAP in the United States is different from GAAP in the UK, or elsewhere.

The International Accounting Standards Board (IASB) develops and promotes a single set of accounting standards for use around the globe. Table 2.1 is a list of the IASs and the contents of some of them are described in more detail later.

Table 2.1 List of IASs

Number	*Title*	*Latest version*
IAS 1	Presentation of Financial Statements	2007
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IAS 2 – INVENTORIES

Inventories are assets held for sale in the ordinary course of business and/or assets in the process of production for such sale and/or the materials or supplies to be consumed in the production process or in the rendering of services. Inventories can therefore include any of the following:

- goods purchased and held for resale, for example by a retailer
- land and buildings held for resale (rather than held for operational use)
- finished goods produced
- work in progress being produced.

The important thing as far as accounting statements is concerned is that inventories are valued at the lower of cost and net realizable value for individual items or groups of similar items.

The cost of an inventory item or group of items includes all costs of purchase, conversion costs, and other costs incurred in bringing the item(s) to their present location and condition. IAS 2 lists types of cost which would not be included in cost of inventories:

- abnormal amounts of wasted materials, labour, or other production costs
- storage costs
- administrative overheads unrelated to production
- selling costs.

For inventories where individual items are interchangeable (for example coal, oil) the following estimation techniques can be used (and whichever method is chosen it must be applied consistently from year to year):

- first-in-first-out (FIFO): where it is assumed that inventory consists of the most recently acquired items; or
- average cost (AVCO): inventories are priced at the weighted average price at which items have been purchased during the period.

The net realizable value (NRV) of an inventory item is the estimated selling price in the ordinary course of business minus the estimated costs of completion and the estimated costs necessary to make the sale. Inventory items should be valued at NRV where the NRV for the item is lower than its cost. This is an example of the principle of prudence in accounting.

IAS 16 – PROPERTY, PLANT, AND EQUIPMENT

Property, plant, and equipment (PPE) are tangible assets that:

- are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- are expected to be used during more than one accounting period.

The recognition of PPE in financial statements depends on two criteria: it must be probable that future economic benefits associated with the asset will flow to the entity; and the cost of the asset to the entity can be measured reliably.

Once an item of PPE qualifies for recognition as an asset, it will initially be measured at cost, which means its purchase price, less any trade discount or rebate, the estimated costs of dismantling and removing the item and restoring the site on which it is located, and directly attributable costs of bringing the asset to working condition for its intended use.

By definition PPE assets are a benefit to the organization over a number of accounting periods. Depreciation is the process of spreading the cost of PPE over the accounting periods for which it provides benefits. In this context cost is the original or revalued cost of the asset minus the expected residual value of the asset at the end of the periods when it will be used. If, for example, a vehicle is bought for $10,000 and is to be used for 3 years, after which it would be expected to have a resale value of $1,000, then the net cost of $9,000 would need to be charged as an expense to the income and expenditure (profit and loss) account over the 3 years the vehicle is used.

The most common methods of depreciation are the straight line method and the reducing balance method. The straight line method takes the depreciable amount and divides it by the number of years of the asset's estimated useful life. This results in the depreciation charge being the same each year. In the example of the vehicle mentioned previously, the charge would be $3,000 in each of the 3 years.

The reducing balance method makes a charge of a constant proportion of the asset's net book value each year. This method results in the depreciation charge reducing each year. To get cumulative depreciation charge of $9,000 over three years for the vehicle, the percentage would need to be approximately 53.6% (giving charges of $5,360, $2,487, and $1,153 in years 1, 2, and 3 respectively).

The choice between these two methods (or any other method) needs to be based on which method best reflects the pattern in which the asset's economic benefits are consumed by the organization. This also means that the method and other parameters might differ for different classes of assets. For example, vehicles and computers might be depreciated using the straight line method over 3 or 5 years, whilst buildings would be depreciated using the reducing balance method over 25 or more years.

The useful economic life of assets should be reviewed each year. If the useful life is judged to have changed, then depreciation in future periods is based on the remaining expected useful life. No change is made to the historical amounts of depreciation charged to the accounts.

IAS 16 offers two treatments to measure the value of PPE assets in subsequent periods after initial recognition. The cost model allows the asset to be valued at its cost minus accumulated depreciation and any accumulated impairment losses. The revaluation model allows the asset to be carried in the accounts at its fair value at the date of the revaluation minus any subsequent accumulated

depreciation and any accumulated impairment losses. The increase (or decrease) in the fair value of an asset is credited (or debited) to a revaluation reserve.

On disposal of an asset a profit or loss may arise if the proceeds from the disposal are greater than or less than the net book value of the asset at the point of disposal. In the accounts the cost of the asset, any revaluation reserve entries and accumulated depreciation are removed; the proceeds from the sale are debited to cash or accounts receivable and the difference (the profit or loss) is credited or charged to income statement.

IAS 36 – IMPAIRMENT OF ASSETS

The preceding section on PPE mentioned that whether assets are carried at cost or at their revaluation value, the value will be reduced by any impairment losses. This is because assets should not be included in the accounts at a value higher than the greater of its fair value minus selling costs and its value in use. This is called the recoverable amount. Fair value is the potential sales proceeds between independent people. The value in use is the present value of future cash flows that the asset is expected to generate for the entity.

An impairment loss occurs if the carrying value in the accounts is greater than the recoverable amount. In that case the value of the asset is reduced by the impairment amount and a debit is made either to the revaluation reserve (if the asset had previously been revalued) or to the income statement as an expense. Note that the depreciation charge for the year for an impaired asset will also need to be adjusted. It is based on the revised carrying amount over its remaining useful economic life.

Whilst the foregoing refers to PPE, the concept of impairment losses applies to other assets, such as investments and accounts receivable.

IS 37 – PROVISIONS

A liability is an obligation of an entity to transfer economic benefits as a result of past transactions or events. Usually an organization knows what its liabilities are and when it must meet them. A provision is used when an organization is uncertain about the timing or amount of a liability.

IAS 37 states that a provision should be recognized as a liability in the financial statements when all three of the following criteria have been met:

1. an entity has a present obligation as a result of a past obligating event;
2. it is probable that an outflow of economic benefits will be required to settle the obligation; and
3. a reliable estimate can be made of the obligation.

Provisions are debited to the income statement as an expense and credited as a liability in the statement of financial position (balance sheet).