

Regulatory and ethical considerations

A2

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Read first: [Preparation of financial statements](#), [Accounting for non-current assets](#), [Types of business entity](#)

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What you need to know

By the end of this topic you should be able to:

1. State and apply the main rules of nine International Accounting Standards (IAS):

- **IAS 1** Presentation of financial statements: what a full set of statements contains and the general rules for presenting them;
- **IAS 2** Inventories: valuing inventory at the lower of cost and net realisable value;
- **IAS 7** Statement of cash flows: what it is for and its three sections;
- **IAS 8** Accounting policies, changes in accounting estimates and errors: how each kind of change or error is dealt with;
- **IAS 10** Events after the reporting period: adjusting and non-adjusting events;
- **IAS 16** Property, plant and equipment: recognising, measuring, depreciating and revaluing non-current assets;
- **IAS 36** Impairment of assets: recoverable amount and impairment losses;
- **IAS 37** Provisions, contingent liabilities and contingent assets;
- **IAS 38** Intangible assets: including research and development costs.

2. Explain why accounting needs an ethical framework.

3. Explain the five fundamental principles that accountants must follow: integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour.

4. Explain how the ethical (or unethical) behaviour of accountants and auditors affects the business and its other stakeholders.

5. Discuss the social implications of business decisions, for employees, customers, the local community and the environment.

6. Explain the role and responsibilities of an auditor.

7. Distinguish an external audit from an internal audit.

8. Distinguish a qualified audit report from an unqualified one.

9. Explain stewardship: the directors' role and their responsibilities to the shareholders.

10. **Explain why financial statements must show a true and fair view.**

11. **Use all of this to judge information and advise** directors or investors, with a justified decision.

Preparing full statements of profit or loss, changes in equity, financial position and cash flows is taught in the preparation of financial statements topics. This note teaches the reasons behind each standard and how to apply it, usually as one adjustment at a time.

Understand it

Why accounting needs rules

The directors of a company prepare its financial statements, but the people who rely on them (shareholders, lenders, suppliers, tax authorities, employees) are usually outsiders. If every company chose its own methods, a reader could not trust the figures or compare one company with another, and directors could make results look better than they are. **International Accounting Standards** fix how common items are measured and shown, so that statements are:

- **comparable** between companies and from year to year;
- **reliable**, because judgement is limited and choices are disclosed;
- **understandable**, because every company uses the same headings.

Two ideas run through all the standards. **Prudence**: don't overstate assets or profit, or understate liabilities.

Matching (accruals): record income and expenses in the period they belong to. When a question asks *why* a standard requires something, one of these is almost always part of the answer, together with "so that the statements show a true and fair view".

IAS 1 Presentation of financial statements

IAS 1 says what a **complete set** of financial statements is:

1. a statement of financial position;
2. a statement of profit or loss (and other comprehensive income, such as a revaluation gain);
3. a statement of changes in equity;
4. a statement of cash flows;
5. notes, including a summary of the **accounting policies** used.

It also sets general rules: the statements must give a **fair presentation**; they are prepared on a **going concern** basis (the business will keep trading) and on the **accruals** basis; each **material** class of items is shown separately; assets and liabilities are not set off against each other; policies and presentation are **consistent** from year to year; **comparative** figures for the previous year are given; and statements are prepared at least once a year.

Assets and liabilities are split into **current** (expected to be used or settled within twelve months) and **non-current**. In the statement of profit or loss, expenses are grouped by **function**:

Heading	What goes in it
Cost of sales	cost of goods sold or made: purchases or cost of production, adjusted for the change in inventory
Distribution costs	getting goods to customers: delivery wages, warehouse rent, delivery vehicle running costs, depreciation and impairment of delivery vehicles
Administrative expenses	running the office: office wages and rent, directors' fees, depreciation of office equipment, the change in the allowance for irrecoverable debts, amortisation, research costs written off
Finance costs	interest on loans and debentures

The **statement of changes in equity** (and the retained earnings account behind it) shows every movement in each reserve: the profit or loss for the year transferred in, dividends paid, a bonus issue funded from a reserve, transfers to the general reserve, and revaluation gains in the revaluation reserve.

IAS 2 Inventories

Inventory is valued at the **lower of cost and net realisable value (NRV)**, item by item (or group by group of similar items), never on the total. This is prudence: if goods will sell for less than they cost, the loss is recognised now.

- **Cost** is everything spent bringing the goods to their present location and condition: purchase price, import duties, carriage inwards and, for a manufacturer, production costs (materials, labour and production overheads). It does **not** include selling or delivery-to-customer costs, storage (unless it is part of production), administration, or abnormal waste.
- **NRV** is the expected selling price less the costs still needed to complete the goods and sell them.
- Cost can be found by **FIFO** or **weighted average cost**. LIFO is not allowed.

For example, goods that cost \$4000 and will sell for \$4500, but need \$700 of repairs and \$200 of selling costs first, have $NRV\ 4500 - 700 - 200 = 3600$. They are valued at \$3600, a write-down of \$400 that reduces profit.

IAS 7 Statement of cash flows

Profit is not the same as cash: depreciation reduces profit but uses no cash, and buying inventory uses cash but is not yet an expense. IAS 7 requires a statement that explains the change in **cash and cash equivalents** (cash, bank balances and short-term deposits, less bank overdrafts) under three headings:

- **Operating activities:** cash from trading. Using the indirect method, start with profit from operations, add back non-cash expenses (depreciation, amortisation, impairment losses, a loss on disposal), take off a profit on disposal, adjust for the changes in inventory, receivables and payables, then deduct interest paid and tax paid.
- **Investing activities:** buying and selling non-current assets (including development costs capitalised).
- **Financing activities:** issuing shares, raising or repaying loans and debentures, and paying dividends.

It shows users whether the business can pay its debts and dividends, and why a profitable business may still be short of cash. Items that move no cash, such as a bonus issue or a revaluation, don't appear at all. The full layout is in the preparation of financial statements topic.

IAS 8 Accounting policies, changes in estimates and errors

An **accounting policy** is a method a business chooses to use, such as valuing inventory by FIFO or measuring buildings at valuation. An **accounting estimate** is a judgement inside a policy, such as an asset's useful life, its residual value, or the percentage for the allowance for irrecoverable debts. IAS 8 treats them differently:

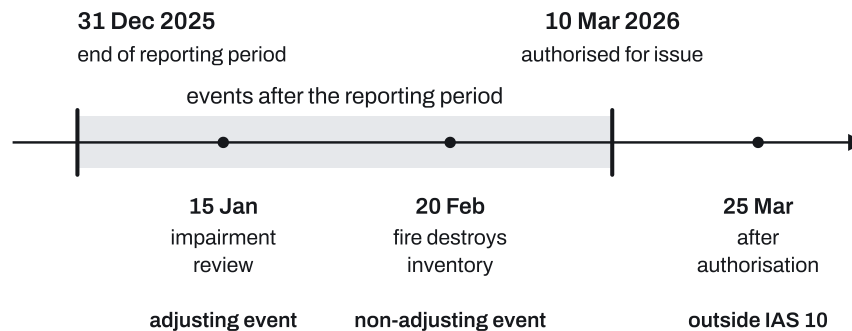
Change	When allowed	How it is dealt with
Change in accounting policy	only if a standard requires it, or if it gives more reliable and relevant information	retrospectively : restate earlier years as if the new policy had always been used, adjusting opening retained earnings
Change in accounting estimate (useful life, residual value, depreciation method, allowance rate)	whenever new information shows a better estimate	prospectively : use the new estimate this year and in future; earlier years are not changed
Prior-period error (a mistake in an earlier year's statements)	must always be corrected	retrospectively : correct the opening retained earnings (and comparative figures), not this year's profit

For example, depreciation of \$15 000 was left out of last year's statements and has been charged in this year's expenses. Last year's profit was overstated, so **opening retained earnings** fall by \$15 000, and **this year's profit** rises by \$15 000 because the charge doesn't belong to it. If the omitted amount covers both years, split it: last year's part against opening retained earnings, this year's part against this year's profit.

The reason is consistency and comparability: this year's profit should show only this year's performance.

IAS 10 Events after the reporting period

Financial statements are made up to the **end of the reporting period** (the year end), but they are finished, audited and **authorised for issue** some weeks later. **Events after the reporting period** are the events, good or bad, that happen between those two dates. Anything after the authorisation date is ignored by the statements.



The test is **when the condition existed**, not when the event happened:

- An **adjusting event** gives evidence about a condition that **already existed at the year end**. The figures are changed. Examples: a customer who owed money at the year end goes bankrupt; inventory held at the year end is sold for less than cost; a court case about something before the year end is settled; an impairment review shows an asset was worth less at the year end; a fraud or error in the year is discovered.
- A **non-adjusting event** shows a condition that **arose after** the year end. The figures are not changed, but if it is **material** (big enough to affect users' decisions) the nature of the event and an estimate of its effect are **disclosed in a note**. Examples: a fire, flood or theft after the year end; a large purchase of assets or of another business; an issue of shares; a fall in the value of investments after the year end; a dividend declared after the year end (it is not a liability at the year end).

One exception: if after the year end the business is going to close (it is no longer a going concern), the statements are not prepared on a going concern basis, even though the decision came after the year end.

IAS 16 Property, plant and equipment

Recognition. An item is recorded as property, plant and equipment when it is **probable that future economic benefits will flow** to the business and its **cost can be measured reliably**. It is held for use for more than one year.

Cost. The purchase price (after trade discounts), import duties and non-refundable taxes, plus all costs **directly needed to get it working**: delivery, installation, site preparation, professional fees and testing. Training staff, general administration, and repairs and maintenance once it is in use are revenue expenditure.

Depreciation allocates the cost (less residual value) over the asset's **useful life**, matching the cost with the income the asset helps to earn. The method should reflect how the benefits are used up. Useful life, residual value and method are reviewed at least each year; a change is a change in estimate (IAS 8). Freehold land usually isn't depreciated.

Measurement after purchase. A business chooses for each **class** of assets either:

- the **cost model**: cost less accumulated depreciation and impairment losses; or
- the **revaluation model**: fair value at the revaluation date less later depreciation and impairment. The whole class must be revalued, and often enough that the carrying amount stays close to fair value.

Businesses revalue so that the statement of financial position is more realistic and depreciation is based on a meaningful current value.

Recording a revaluation.

1. Find the carrying amount at the revaluation date (charge depreciation up to that date first).
2. Remove the accumulated depreciation: Dr accumulated depreciation, Cr asset account.
3. Bring the asset account up to the new value: Dr asset account, Cr **revaluation reserve** with the **increase over carrying amount**.

In one entry: Dr asset account (valuation — cost), Dr accumulated depreciation (all of it), Cr revaluation reserve (valuation — carrying amount). For example, premises cost \$300 000 with accumulated depreciation \$60 000 are revalued at \$400 000: the reserve is $400\,000 - 240\,000 = 160\,000$. From then on, depreciation is based on the \$400 000.

The revaluation reserve is a **capital reserve**: the gain is unrealised, so it **cannot be used for dividends** and does not go through profit. A revaluation therefore has no effect on profit or on the amount available for dividends.

A fall in value is an expense in the statement of profit or loss, **except** that it is first set against any revaluation reserve already held for **that same asset**. For example, land revalued from \$200 000 to \$260 000 (reserve \$60 000) and later valued at \$180 000: the fall of \$80 000 uses the \$60 000 reserve first, and the remaining \$20 000 is an expense.

Disposal. The difference between the proceeds and the carrying amount is a profit or loss on disposal in the statement of profit or loss.

The notes show a **schedule of non-current assets** for each class: cost or valuation and accumulated depreciation at the start, additions, disposals, revaluations, impairment, the depreciation charge, and the carrying amounts. Revaluation and impairment are rows in that schedule.

IAS 36 Impairment of assets

An asset is **impaired** when its carrying amount is **more than it is really worth to the business**. IAS 36 exists so that assets are not overstated (prudence) and the statements show a true and fair view.

At each year end the business looks for signs of impairment:

- **outside the business:** the asset's market value has fallen sharply, new technology has made it out of date, the market it serves has shrunk;
- **inside the business:** it is damaged or idle, it is performing worse than expected, there are plans to stop using it.

If there are signs, it compares the carrying amount with the **recoverable amount**. An asset can earn money for the business in two ways, by being sold or by being used, and a sensible business would choose the better one. So:

$$\text{recoverable amount} = \text{the higher of } \begin{cases} \text{fair value less costs to sell} \\ \text{value in use} \end{cases}$$

- **Fair value less costs to sell** is what it could be sold for, less the costs of selling it (dismantling, transport, commission).
- **Value in use** is the present value of the future net cash flows from continuing to use it.

$$\text{impairment loss} = \text{carrying amount} - \text{recoverable amount} \quad (\text{only if this is positive})$$

If the recoverable amount is **equal to or higher than** the carrying amount, there is **no impairment**; the asset is **not** written up. For example, a van has a carrying amount of \$20 000. It could be sold for \$16 000 with costs of \$500, and its value in use is \$17 200. Fair value less costs to sell = 15 500, so the recoverable amount is \$17 200 and the impairment loss is 20 000 – 17 200 = 2800.

Recording it. The loss is an **expense** in the statement of profit or loss (under the heading the asset belongs to, such as distribution costs for a delivery vehicle): Dr impairment loss (statement of profit or loss), Cr accumulated depreciation (or Cr the asset account). If the asset had been revalued, the loss is first set against its revaluation reserve. The carrying amount falls to the recoverable amount, and future depreciation is based on that lower figure over the remaining life. Goodwill and intangible assets without a fixed life are tested every year, whether or not there are signs.

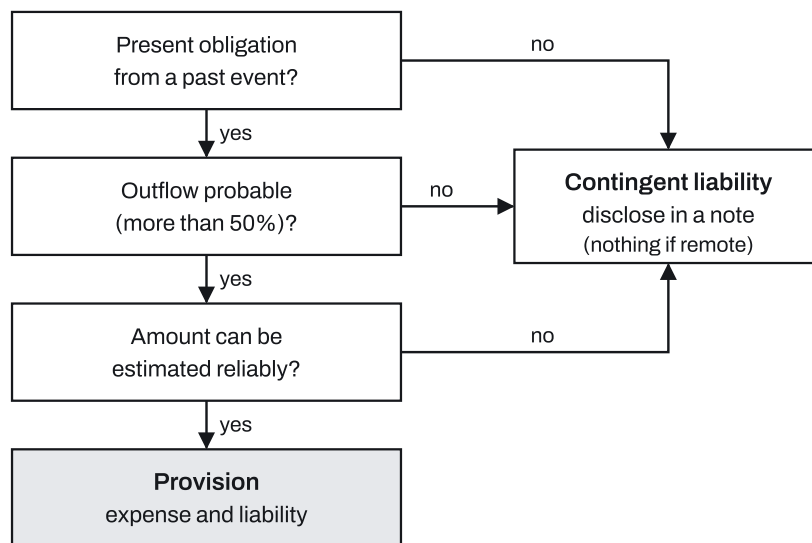
IAS 37 Provisions, contingent liabilities and contingent assets

A **provision** is a liability whose **timing or amount is uncertain**, such as damages the business expects to pay for an accident. It is recognised only if **all three** conditions are met:

1. there is a **present obligation** (legal, or one the business has created by its own actions) **as a result of a past event**;
2. it is **probable** (more likely than not, over 50%) that money or other resources will flow out to settle it;
3. a **reliable estimate** of the amount can be made.

A provision is measured at the **best estimate** of what will be paid. It is recorded as an expense (Dr the expense, Cr provision) and shown as a liability. Legal costs that the business will have to pay for work already done are provided for too.

If the conditions are not all met, the item is a **contingent liability**: a possible obligation whose existence depends on uncertain future events, or a present obligation that is not probable or can't be measured reliably. It is **not recorded**; it is **disclosed in a note**, unless the chance of paying is **remote**, in which case nothing is shown.



A **contingent asset** is a possible asset from past events that depends on uncertain future events outside the business's control, such as damages the business hopes to win in a court case. It is **never recorded** while uncertain (prudence: don't count gains before they are made). It is disclosed in a note if the inflow is **probable**, and recognised as an asset only when it is **virtually certain**.

The asymmetry is deliberate: a probable loss is recorded, a probable gain is only disclosed.

IAS 38 Intangible assets

An **intangible asset** is an **identifiable** non-monetary asset **without physical substance**: patents, trademarks, brands bought from others, licences, copyrights, software, purchased goodwill and capitalised development costs. Like IAS 16, it is recognised only when **future economic benefits are probable** and the **cost can be measured reliably**. That is why internally generated goodwill, brands and customer lists are **not** recorded: their cost can't be separated from the cost of running the business.

Research and development is the part most often examined.

- **Research** is original investigation to gain new knowledge (for example, testing new materials). Nobody can show yet that it will bring future income, so research costs are **always written off** as an expense (revenue expenditure) when they are incurred.
- **Development** is using that knowledge to design a specific new or improved product or process before it is made commercially. Development costs are **capitalised** (capital expenditure, shown as an intangible asset) **only if the business can show all of these**: the product is technically feasible; it intends to complete it and use or sell it; it is able to use or sell it; there is a market, so it will bring probable future economic benefits; it has the resources to finish it; and the costs can be measured reliably. If any test fails, development costs are written off like research.

Capitalised development costs are **amortised** (depreciated) over the product's useful life, starting when it becomes available for use or sale. Intangible assets with a limited life are amortised; those with no fixed life are not, but are tested for impairment every year.

Capitalising development costs raises profit and assets now, but writing them off is more prudent, which is why the tests are strict.

Ethics: why accountants need a framework

Accountants and auditors hold information and judgement that others rely on but can't check for themselves. Directors may be under pressure to hit targets, get bonuses or keep lenders happy, and an accountant may be asked to "help". A professional **ethical framework** (a code of ethics set by the professional bodies) gives accountants clear principles to follow when the rules don't settle a question, protects the public's trust in financial information, and lets an accountant refuse improper requests with the backing of their profession.

The **five fundamental principles**:

Principle	What it means	A breach would be...
Integrity	being straightforward and honest in all professional and business dealings	knowingly signing off figures you know are misleading
Objectivity	not letting bias, conflicts of interest or pressure from others override professional judgement	an auditor who owns shares in the client, or who gives way to a director's threats
Professional competence and due care	keeping knowledge and skills up to date, and working carefully, thoroughly and on time, following standards	preparing statements under a new standard you haven't learned, or rushing the work
Confidentiality	not disclosing information obtained through work without proper authority (unless there is a legal or professional duty to), and not using it for personal gain	telling a friend about an unannounced takeover so they can buy shares
Professional behaviour	obeying laws and regulations and avoiding anything that discredits the profession	making false claims about your qualifications, or criticising other accountants unfairly

How ethical behaviour affects the business and stakeholders. When accountants and auditors act ethically, the statements show a true and fair view, so shareholders, lenders and suppliers can make sound decisions; the company keeps its reputation, can raise finance more cheaply, and avoids fines and legal action. Unethical behaviour (hiding losses, overstating assets) misleads investors into buying overvalued shares, leads lenders to lend to a business that can't repay, and can end in collapse, with employees losing jobs and suppliers going unpaid. The accountant risks losing their membership of the professional body and their job.

Social implications of decision-making. A business decision affects more than the shareholders. Closing a factory to cut costs raises profit but causes unemployment in the local community; cutting pollution or greenhouse gas emissions costs money now but improves the business's reputation, can create brand loyalty

and raise future profits and the share price; using cheaper suppliers who treat workers badly damages reputation if it becomes known. When advising on a decision, weigh the financial effect against the effect on employees, customers, the community and the environment, then reach a conclusion.

Stewardship and directors' responsibilities

In a limited company, the **owners** (shareholders) and the **people in control** (directors) are usually different people. The shareholders entrust the company's resources to the directors. **Stewardship** is the directors' duty to look after those resources and manage the business **in the shareholders' best interests**, and to **account** to them for how they have done it, which is what the annual financial statements are for.

The directors are responsible for:

- keeping proper accounting records;
- **preparing** the financial statements so that they show a true and fair view and comply with the law and IAS;
- safeguarding the company's assets and preventing and detecting fraud and errors (for example, through internal controls);
- acting with integrity and avoiding conflicts between their own interests and the company's;
- preparing a **directors' report** (reviewing the year and future plans, dividends, directors' names and interests, material events after the reporting period, donations, employment policies).

Because the directors report on their own performance, the shareholders need someone independent to check that report: the auditor.

Auditing

An **audit** is an independent examination of a company's financial statements and records so that the auditor can give an **opinion** on whether they show a **true and fair view** and have been prepared in line with the law and IAS.

Directors prepare the statements; the external auditor reports on them. The auditor does not prepare them and does not guarantee they are perfect.

An external auditor's **responsibilities**: examine the books and supporting documents; test the internal controls; check that the statements follow the law and IAS; verify that assets and liabilities exist and are correctly valued; and report to the shareholders.

External audit	Internal audit
appointed by the shareholders (at the general meeting)	appointed by the directors (management)
independent of the company; paid a fee	employees of the company; paid a salary
must be professionally qualified	need not be professionally qualified
usually once a year , after the year end	throughout the year

External audit	Internal audit
reports to the shareholders with an opinion on the financial statements	reports to the directors; reviews internal controls, systems and efficiency and makes recommendations
required by law for companies	chosen by the business

The audit report.

- An **unqualified** (clean) report says the statements **do** show a true and fair view. It is the **good** outcome: shareholders and lenders can rely on the figures, confidence in the directors and the company is maintained, and the share price is supported.
- A **qualified** report says the statements show a true and fair view **except for** a stated problem: the auditor disagrees with how something material has been treated, or couldn't get enough evidence (for example, because records were lost). It is a warning. Shareholders lose confidence in the directors, may question them at the general meeting or vote against them, and the share price may fall; lenders may be less willing to lend.

True and fair view

Statements show a **true and fair view** when they are **free from material misstatement**, **comply** with IAS and company law, are **neutral** (not biased to flatter the results), are prepared **consistently**, and **faithfully represent** what happened. It matters because shareholders, lenders and other users make decisions on them; it is the directors' **legal duty**; and failing it leads to a qualified audit report and loss of confidence. So a director who says a true and fair view "doesn't matter" is wrong.

Key facts and formulas

There is no formula list in the 9706 exam, so learn all of these.

Formula	Status
Inventory (IAS 2) = lower of cost and NRV, item by item; NRV = selling price – costs to complete – costs to sell	Learn it
Fair value less costs to sell = selling price – costs of disposal	Learn it
Recoverable amount (IAS 36) = higher of fair value less costs to sell and value in use	Learn it
Impairment loss = carrying amount – recoverable amount, if positive (otherwise 0)	Learn it
Depreciation after impairment = recoverable amount ÷ remaining useful life (straight line)	Learn it

Formula	Status
Revaluation reserve (IAS 16) = revalued amount – carrying amount at the revaluation date	Learn it
Fall in value: set against that asset's revaluation reserve first; the rest is an expense	Learn it
Provision (IAS 37): present obligation from a past event + probable outflow (> 50%) + reliable estimate	Learn it
Contingent liability: note only; remote: nothing. Contingent asset: note only if probable; asset only if virtually certain	Learn it
Adjusting event: condition existed at the year end (change figures). Non-adjusting: arose after (note if material)	Learn it
Prior-period error or change of policy (IAS 8): adjust opening retained earnings. Change of estimate: this year and future only	Learn it
Intangible asset or PPE recognised when future benefits are probable and cost can be measured reliably	Learn it
Research: always an expense. Development: capitalise only if all IAS 38 tests are met; amortise from when available for use	Learn it
Amortisation (straight line) = cost ÷ useful life	Learn it

How to do it

We have 25 tagged questions for this topic from 2021 to 2025, all parts of 25-mark Paper 3 questions (23 different, as two appear on two paper variants). 17 of them mix more than one type, so the counts add up to 58. Parts on ratios or on preparing full statements belong to other topics.

Question type	Questions
Adjust draft profit or a statement of financial position for a list of IAS items	9
Calculate recoverable amount and impairment loss (IAS 36)	7
Classify and explain events after the reporting period (IAS 10)	7
Non-current assets schedule or extract with revaluation and impairment (IAS 16 and 36)	7
Apply IAS 37: provisions, contingent liabilities and contingent assets	5
Explain the role and responsibilities of auditors	5
Explain stewardship, directors' responsibilities and a true and fair view	5
Apply IAS 38: research and development and intangible assets	4
Explain revaluation and depreciation principles (IAS 16)	4

Question type	Questions
Explain an item's treatment, naming the right IAS (IAS 8, IAS 2)	3
Explain an ethical principle or the social implications of a decision	2

1. Adjust draft profit or a statement of financial position for a list of IAS items (9 questions)

You are given a draft profit (or retained earnings, or a statement of financial position) and five to eight numbered items the draft ignored.

1. **Set out a statement:** start with the draft figure, then **one line per item**, with a label and a sign (brackets for a decrease), then the corrected total.
2. **Decide each item's treatment** with the standard:

Item	Effect on profit
Irrecoverable debt written off (a customer who owed at the year end goes bankrupt after it: adjusting event)	decrease
Change in allowance for irrecoverable debts	increase in allowance: decrease; fall: increase
Inventory with NRV below cost (IAS 2)	decrease by cost — NRV
Goods on sale or return treated as sold	decrease by selling price, increase by cost (net: the profit margin)
Impairment loss (IAS 36)	decrease by carrying amount — recoverable amount
Depreciation or amortisation not charged / overcharged	decrease / increase
Revenue expenditure (repairs, servicing) wrongly added to an asset (IAS 16)	decrease by the part for this year (any part for next year is a prepayment); remove any depreciation charged on it
Proceeds from selling a non-current asset recorded as income (IAS 16)	decrease by the proceeds, then add back only the profit on disposal (proceeds — carrying amount)
Probable lawsuit or legal costs (IAS 37 provision)	decrease
Possible lawsuit (contingent liability), contingent asset, non-adjusting event	no change: note only
Revaluation gain (IAS 16)	no change: revaluation reserve
Revaluation loss wrongly charged to profit where a reserve exists	increase (move it to the reserve)
Research costs capitalised	decrease; development costs meeting the tests but written off: increase

Item	Effect on profit
Prior-period error charged this year (IAS 8)	increase this year's profit; adjust opening retained earnings
Uninsured part of a loss	decrease by the part the insurer won't pay

3. **Show workings** for any item needing a calculation (NRV, impairment, allowance).

4. **For a statement of financial position**, follow each item into the balance sheet too: an impairment lowers property, plant and equipment; a provision goes in liabilities (current, if due within a year); irrecoverable debts and sale-or-return goods lower trade receivables (and sale-or-return goods raise inventory at cost); a revaluation raises the asset and the revaluation reserve; every profit change goes to retained earnings.

Variations you will meet:

- **"Identify the items disclosed only by a note, and explain"**: these are the contingent liabilities, probable contingent assets and material non-adjusting events. Name the item, the standard, and the reason (for example, "only a 35% chance, so possible not probable").
- **A proposed dividend** in the draft: dividends proposed after the year end are not liabilities, so add it back to retained earnings and remove it from payables.
- **Start from profit from operations** rather than profit for the year: interest goes below that line, so don't adjust it.

2. Calculate recoverable amount and impairment loss (IAS 36) (7 questions)

1. **Carrying amount** = cost – accumulated depreciation, **including depreciation up to the review date**.
2. **Fair value less costs to sell** = selling price – dismantling, transport, commission.
3. **Value in use** is given (the present value of future cash flows).
4. **Recoverable amount** = the higher of 2 and 3. Say which, and why.
5. **Impairment loss** = carrying amount – recoverable amount if positive; otherwise "no impairment" (\$0).

Variations you will meet:

- **A table of several assets**: work each line separately; an asset whose recoverable amount is above its carrying amount has a loss of \$0 and is not written up.
- **"State how the recoverable amount is determined" or "explain what is meant by"**: "the higher of fair value less costs to sell and value in use", with each term explained.
- **"Explain why a business may need to impair assets" / "why keep doing impairment reviews"**: prudence, so assets aren't overstated; the carrying amount must not exceed what the asset can earn; the statements show a true and fair view; to comply with IAS 36 and avoid a qualified audit report.
- **Journal entry**: Dr impairment loss (statement of profit or loss), Cr accumulated depreciation (or provision for depreciation). If asked to clear the asset to its new value: Dr accumulated depreciation (the whole balance), Dr impairment loss, Cr asset account (the difference between cost and recoverable amount).

- **"Explain how the loss is recorded"**: an expense in the statement of profit or loss, reducing profit; the carrying amount in the statement of financial position falls to the recoverable amount; future depreciation is based on the lower amount.
- **Which ratio is affected**: non-current asset turnover rises, because the non-current assets are lower.

3. Classify and explain events after the reporting period (IAS 10) (7 questions)

1. **Definition**: events, favourable or unfavourable, between the end of the reporting period and the date the statements are authorised for issue.
2. **Classify**: ask "did the **condition** exist at the year end?" Yes: **adjusting**, change the figures. No: **non-adjusting**, don't change them.
3. **Give the treatment**: adjusting, say which figures change and by how much; non-adjusting, disclose the nature and estimated effect in a note **if material**.

Variations you will meet:

- **An impairment review a few days after the year end**: adjusting, because it shows the asset's value at the year end.
- **A fire, flood or theft after the year end**: non-adjusting. The inventory existed and was worth its value at the year end, so nothing changes; disclose by note, with the uninsured loss if material.
- **Two dated events to classify**: one mark each for the right word, and a mark for the reason when asked.

4. Non-current assets schedule or extract with revaluation and impairment (IAS 16 and 36) (7 questions)

The layout of the schedule is covered in the non-current assets and preparation topics; this topic adds the IAS rows.

1. **Revaluation row**: in the cost section, add (valuation — cost) to bring the asset to its valuation; in the depreciation section, **remove all the accumulated depreciation** up to the revaluation date.
2. **Depreciation after a revaluation** is on the revalued amount over the remaining life.
3. **Impairment row**: show the loss in the depreciation section as "impairment", or reduce the cost section to the recoverable amount and clear the accumulated depreciation, as the question's layout suggests.
4. The **carrying amount** at the end is cost or valuation less accumulated depreciation and impairment.

For a statement of financial position extract, show intangible assets (goodwill, development costs) separately from property, plant and equipment.

5. Apply IAS 37: provisions, contingent liabilities and contingent assets (5 questions)

1. **State the three conditions** if asked: present obligation from a past event; probable outflow; reliable estimate.
2. **Apply them to each item**, using the probability given:

- "probably liable", "likely to lose", more than 50%: **provision** at the best estimate (an expense and a liability);
- "possible", "35% chance": **contingent liability**, disclosed by note, no figures change;
- "remote", "very unlikely": **nothing**;
- legal costs for work done: **provision** (or accrual).

3. **Contingent asset**: define it (a possible asset from a past event, depending on uncertain future events outside the business's control) with an example (damages expected from a court case, an insurance claim in dispute); not recognised.

Variations you will meet:

- **Name the standard** at the start of any explanation: "IAS 37 Provisions, contingent liabilities and contingent assets" earns a mark.
- **Advise whether to pay a dividend while a claim is outstanding**: for paying, shareholders expect it, the dividend policy has been consistent, and the claim is only a contingent liability; against, keep cash in case the claim succeeds and avoid borrowing. End with a decision and a reason.

6. Explain the role and responsibilities of auditors (5 questions)

1. **Responsibilities of an external auditor**: examine the records, test controls, check compliance with the law and IAS, verify assets and liabilities, and report whether the statements show a true and fair view. Give as many distinct points as marks.
2. **External vs internal**: pair the points, each side of the same feature (appointed by / paid by / qualification / timing / what they report on). "State two differences" with 4 marks needs both sides of each difference.
3. **Directors vs auditor**: directors **prepare** the statements; the auditor **reports** on them.
4. **Qualified vs unqualified**: say which is good news, and what shareholders do.

Variations you will meet:

- **Lost or deleted records**: for the directors, they are still responsible and should improve backups, controls and staff training; for the auditors, extra work to verify figures, and possibly a qualified report if they can't.
- **Would auditors be interested in ratios?** Not directly (ratios aren't part of the statements they give an opinion on), but yes as a tool to spot unusual figures that need more testing. Give both sides.

7. Explain stewardship, directors' responsibilities and a true and fair view (5 questions)

1. **Stewardship** (usually 4 marks, 2 points each developed): ownership and control are separate, **so** directors are accountable to the shareholders; shareholders entrust the resources to them, **so** they must manage them in the shareholders' best interests; they must act with integrity and avoid conflicts of interest, **so** they report honestly through the financial statements.
2. **Features of a true and fair view**: free from material misstatement; complies with IAS and law; neutral; consistent; faithful representation.

3. **"Comment on a director who says it doesn't matter"**: say whether the statement is correct, then justify: legal duty; shareholders and lenders rely on it; otherwise a qualified audit report and a loss of confidence.

Variation: what a directors' report contains: review of the year, future developments, dividends, directors and their interests, material events after the reporting period, donations, employee policies.

8. Apply IAS 38: research and development and intangible assets (4 questions)

1. **Recognition**: probable future economic benefits and a cost that can be measured reliably.
2. **Split the costs**: research, and development failing any test, are **revenue expenditure** (expense); development meeting **all** the tests is **capital expenditure** (intangible asset).
3. **Amortise** the capitalised amount over the useful life, from when the product is available.
4. **Name intangible assets** if asked: patent, trademark, brand, licence, copyright, purchased goodwill.

Variations you will meet:

- **Explain entries in a research and development account**: the amount to the statement of profit or loss is the part written off (pure research, or no proven future benefit); the balance carried down is the part capitalised (it will bring future benefit).
- **Advise on capitalising development costs**: for, profit and assets are higher and matching is better if the product will earn income; against, it is less prudent, and IAS 38 allows it only when the tests are met. Decision with a comment.

9. Explain revaluation and depreciation principles (IAS 16) (4 questions)

1. **Revaluation journal with narrative**: Dr asset (increase), Dr accumulated depreciation (if any), Cr revaluation reserve; narrative "Revaluation of premises on (date)".
2. **Calculate the reserve**: valuation — carrying amount **at the revaluation date**, after depreciation for the months before it.
3. **Why revalue**: more realistic statement of financial position; depreciation on a meaningful value.
4. **Effect on dividends**: none, because the revaluation reserve is a capital reserve and not distributable.
5. **Why depreciate**: matching the cost with the revenue it helps earn over its useful life; showing the asset at a realistic value.
6. **Straight-line vs reducing balance**: reducing balance charges more in the early years (lower profit then, higher later); straight-line spreads it evenly. Total over the life is the same.

10. Explain an item's treatment, naming the right IAS (IAS 8, IAS 2) (3 questions)

1. **Name the standard in full** (1 mark each time).
2. **State the rule and apply it with the figure**:
 - IAS 8, prior-period error: adjust the opening retained earnings for the earlier year's part; this year's part goes against this year's profit.
 - IAS 2: inventory at the lower of cost and NRV, so it is valued at \$(the lower figure).

11. Explain an ethical principle or the social implications of a decision (2 questions)

1. **Name the principle** and say what it requires.
2. **Apply it to the scenario**: who is affected and how (shareholders, lenders, employees, the auditor's opinion).
3. For **professional competence and due care**, the benefits are: statements that show a true and fair view, comply with IAS and law, can be compared and relied on for decisions, and avoid a qualified audit report.
4. For **social implications**, give the financial effect and the effect on reputation, customers, employees or the environment, then the likely effect on future profit or share price.

Worked examples

The bold codes show where marks are earned, as in Cambridge mark schemes. The number is how many marks.

- **M1** method mark: for a correct method, even if the numbers slip.
- **A1** accuracy mark: for a correct answer; it needs the M mark before it.
- **B1** mark for a correct result on its own, with no method needed.

Example 1

A machine was bought on 1 January 2023 for \$60 000 and is depreciated at 10% per year on cost (a ten-year life, no residual value). The company's year end is 31 December. On 15 January 2026, before the 2025 statements were authorised for issue, an impairment review found:

- the machine could be sold for \$36 500, but dismantling and delivery would cost \$1700;
- the present value of the future net cash flows from using it is \$38 500.

- (a) Explain what is meant by the recoverable amount of an asset. **[2]**
- (b) Calculate the impairment loss at 31 December 2025. **[4]**
- (c) State, with a reason, whether the review is an adjusting or a non-adjusting event. **[2]**
- (d) Prepare the journal entry to record the impairment. A narrative is not required. **[2]**
- (e) Calculate the depreciation charge for 2026, assuming the remaining useful life is unchanged. **[2]**

(a) It is the **higher B1** of the asset's fair value less costs to sell and its value in use **B1**.

(b) Carrying amount = $60\,000 - 3 \times 6000 = 42\,000$. **B1**

Fair value less costs to sell = $36\,500 - 1700 = 34\,800$. **B1**

Recoverable amount = the higher of \$34 800 and \$38 500 = \$38 500. **B1**

Impairment loss = 42 000 – 38 500 = 3500. **B1** (own figures)

(c) Adjusting **B1**: the review gives evidence of the machine's value, a condition that existed at 31 December 2025 **B1**.

(d)

	Dr \$	Cr \$
Impairment loss (statement of profit or loss)	3500	
Accumulated depreciation of machinery		3500

B1 each line, with the right account names.

(e) The machine has $10 - 3 = 7$ years left, so depreciation = $38\,500 \div 7 = 5500$. **M1 A1** (Charging the old \$6000 ignores the lower carrying amount.)

Example 2

K plc's year end is 31 March 2026. The draft profit for the year was \$148 600. Its statements will be authorised for issue on 30 June 2026. The draft did not take account of these items.

1. A customer was injured in one of K plc's shops in February 2026 and is suing for \$40 000. K plc's lawyers say the company will probably lose and estimate that it will have to pay \$24 000.
2. The lawyers have also done work on item 1 up to 31 March 2026, which will cost \$2500. No invoice has been received.
3. A supplier is suing K plc for \$15 000 over a cancelled contract. The lawyers put K plc's chance of losing at 20%.
4. K plc is suing a competitor for copying its patented design. The lawyers think it is likely to win damages of \$30 000.
5. On 20 April 2026 a credit customer who owed \$3200 at 31 March went into liquidation. Nothing will be recovered.
6. On 2 May 2026 a flood destroyed inventory that cost \$11 000. It was not insured.

(a) State the three conditions for recognising a provision under IAS 37. **[3]**

(b) Calculate the corrected profit for the year. **[5]**

(c) Identify the items that should be disclosed only by a note to the financial statements, and explain why. **[6]**

(a) There is a present obligation as a result of a past event **B1**; an outflow of resources to settle it is probable **B1**; a reliable estimate of the amount can be made **B1**.

(b)

	\$
Draft profit for the year	148 600
1 Provision for damages	(24 000) B1
2 Provision for legal costs	(2 500) B1
5 Irrecoverable debt	(3 200) B1
Corrected profit for the year	118 900 B1

B1 for leaving out items 3, 4 and 6. The damages are provided at the best estimate of what will be paid (\$24 000), not the amount claimed.

(c)

- **Item 3:** a contingent liability (IAS 37) **B1**. With a 20% chance, the outflow is possible but not probable **B1**, so it is disclosed in a note but not recorded.
- **Item 4:** a contingent asset (IAS 37) **B1**. The inflow is probable but not virtually certain, so it is disclosed by note and not recognised, which is prudent **B1**.
- **Item 6:** a non-adjusting event (IAS 10) **B1**. The flood happened after the year end, so the inventory was worth its full value at 31 March; the loss is material, so it is disclosed in a note **B1**.

(Item 5 is also after the year end, but it is **adjusting**: the customer already owed the money and was already in difficulty at 31 March.)

Example 3

L plc's draft profit for the year ended 31 December 2025 was \$212 000. The following have been discovered.

1. Inventory includes goods that cost \$9400. They can be sold for \$8200, but only after repairs of \$1300 and selling costs of \$600.
2. Of \$45 000 spent on a new product during the year, \$12 000 was on testing new materials and \$33 000 was on designing the product, which meets all the IAS 38 tests. The product will go on sale in 2026. All \$45 000 was charged as an expense.
3. Premises that cost \$420 000, with accumulated depreciation of \$40 000, were revalued at \$450 000 on 31 December 2025. The accountant credited the gain to the statement of profit or loss.
4. Depreciation of \$8000 on a machine was left out of the 2024 statements. It has been included in the 2025 expenses.

(a) Calculate the corrected profit for the year. **[6]**

(b) Explain the treatment of item 4, with reference to the relevant International Accounting Standard. **[3]**

(c) Prepare the journal entry to record item 3 correctly. A narrative is required. **[3]**

(d) A director says the revaluation means the company can pay a larger dividend. Comment on this. **[2]**

(a) Item 1: $NRV = 8200 - 1300 - 600 = 6300$, below cost, so write down by $9400 - 6300 = 3100$. **B1**

Item 3: $gain = 450\,000 - (420\,000 - 40\,000) = 70\,000$.

	\$
Draft profit for the year	212 000
1 Inventory written down to NRV	(3 100) B1
2 Development costs capitalised	33 000 B1
3 Revaluation gain removed	(70 000) B1
4 Prior-year depreciation removed	8 000 B1
Corrected profit for the year	179 900 B1

No amortisation is charged on the development costs yet, because the product is not available for sale until 2026. The \$12 000 on testing materials is research and stays an expense.

(b) IAS 8 Accounting policies, changes in accounting estimates and errors **B1**. The \$8000 is a prior-period error **B1**, so it is corrected against the retained earnings at 1 January 2025, not against the 2025 profit **B1**.

(c)

	Dr \$	Cr \$
Premises (\$450 000 – \$420 000)	30 000	
Accumulated depreciation of premises	40 000	
Revaluation reserve		70 000

B1 asset and accumulated depreciation, **B1** revaluation reserve, **B1** narrative: "Revaluation of premises to \$450 000 on 31 December 2025."

(d) The director is wrong **B1**: the revaluation reserve is a capital reserve made of an unrealised gain, so it cannot be used to pay dividends **B1**.

Example 4

The finance director of M plc asks the company accountant, Rosa, to leave a large irrecoverable debt out of this year's statements, so that profit reaches the level that triggers the directors' bonuses. The debt was known to be irrecoverable before the year end.

(a) Identify two fundamental ethical principles Rosa would break by agreeing, and explain each. **[4]**

(b) Explain the stewardship role of the directors of M plc. **[4]**

(c) State two differences between an external auditor and an internal auditor. **[4]**

(d) Explain how the shareholders are likely to react if the external auditor gives a qualified report on this year's statements. [3]

(a) Integrity B1: Rosa would knowingly make the statements misleading, overstating profit and trade receivables, which is dishonest **B1**. **Objectivity B1:** she would be letting pressure from the finance director, who has a personal interest in the bonus, override her professional judgement **B1**. (Professional behaviour, breaking IAS and company law, is also credited.)

(b) In a plc, ownership and control are separate **B1**, so the directors are accountable to the shareholders **B1**. The shareholders entrust the company's resources to the directors to manage **B1**, and the directors must act in the shareholders' best interests, with integrity and avoiding conflicts of interest such as this bonus **B1**.

(c) An external auditor is appointed by the shareholders **B1**, while an internal auditor is appointed by the directors **B1**. An external auditor is independent and paid a fee, and gives an opinion on the financial statements once a year **B1**; an internal auditor is an employee who reviews systems and controls throughout the year **B1**.

(d) A qualified report says the statements do not show a true and fair view in some material respect **B1**. The shareholders would lose confidence in the directors and the figures, and may question or vote against them at the general meeting **B1**. Some may sell their shares, so the share price may fall **B1**.

Common mistakes

- **Picking the lower value for the recoverable amount.** It is the **higher** of fair value less costs to sell and value in use; the loss is then carrying amount minus that. Examiners report that the recoverable amount is the value most often got wrong.
- **Forgetting the costs to sell.** Fair value less costs to sell means taking off dismantling, transport or commission first; many candidates quote the selling price alone.
- **Using the wrong carrying amount.** Charge depreciation up to the review or revaluation date (for example, nine months to 30 September) before comparing values or calculating a revaluation reserve.
- **Writing an asset up when the recoverable amount is higher.** If it is above the carrying amount the loss is \$0; IAS 36 never increases the value.
- **Classifying by when the event happened, not when the condition existed.** A customer who owed money at the year end and goes bankrupt in January is **adjusting**; a fire in January is **non-adjusting**. Examiners see this confusion often, and few candidates treat the fire correctly.
- **Changing the figures for a contingent liability.** A possible (under 50%) loss is a note, not an expense. And don't forget the **legal costs**: they are usually a provision even when the claim is only contingent.
- **Knowing IAS 37 but not applying it.** Quote the probability in the question and say what it means ("probably liable, so a provision of \$9000").
- **Putting a revaluation gain through profit, or using it for dividends.** It goes to the revaluation reserve, which is not distributable. A later fall uses that reserve first, and only the excess is an expense.
- **Thinking an unqualified report is bad news.** "Unqualified" means the auditor found nothing to qualify: the statements show a true and fair view. Many candidates get this backwards.

- **Listing too few points.** "State three responsibilities of an external auditor" needs three different ones; most candidates manage only one or two.
- **Not naming the standard.** "With reference to the relevant IAS" means give its number **and** name. IAS 8 is the one most often missed.
- **Defining without applying.** A definition of stewardship earns the first marks; the rest go to linking it to the scenario (the bonus, the purchase, the missing records).
- **Capitalising research.** Only development that meets every IAS 38 test can be capitalised; research is always written off.

How to get the marks

- **Name the standard in full** ("IAS 36 Impairment of assets") whenever a question says "with reference to the IAS". It is usually a mark on its own.
- **Adjustment statements:** one clearly labelled line per item, with brackets for decreases, and workings under the statement. Each correct line earns its mark even if the total is wrong, because totals are marked on your own figures.
- **Items with no effect** (contingent liabilities, non-adjusting events, revaluation gains): leave them out of the statement, and if asked, say why in one sentence with the standard.
- **Impairment:** show the carrying amount, both values, which is higher, and the loss, each on its own line. There is a mark for each.
- **Journals:** debit first, correct account names, amounts, and a narrative only when the question asks for one.
- **"State"** needs a short answer, one point per mark. **"Explain"** needs the point and the reason ("... because..."). **"Discuss"** needs both sides.
- **"Advise ... Justify your answer"** (usually 5 marks): up to two points for, up to two against, then a clear decision with a reason. A decision with no justification earns little.
- **Two differences** for 4 marks means both sides of each difference: "appointed by the shareholders, whereas internal auditors are appointed by the directors".
- **Stewardship** (4 marks): two basic points, each developed with "so" or "because".
- **Use the scenario:** marks for ethics, auditing and social implications usually need you to apply the idea to the company in the question.

Quick check

1. A delivery van has a carrying amount of \$18 000. It could be sold for \$15 000, with selling costs of \$800. Its value in use is \$16 500. Calculate the recoverable amount and the impairment loss.
2. A company's year end is 31 December 2025. State whether each of these is an adjusting or a non-adjusting event: (a) in February 2026, inventory held at the year end is sold for less than cost; (b) in February 2026, the company issues 100 000 new shares; (c) in March 2026, the directors declare a dividend for 2025.

3. A customer is suing a company for \$50 000. Explain how the claim is treated if the company's lawyers say the chance of losing is (a) 30%, (b) 70%, with the best estimate of the payment being \$50 000.
4. Land that cost \$250 000 was revalued at \$320 000. A year later it is valued at \$230 000. Calculate the revaluation reserve after the first revaluation, and the amount charged to the statement of profit or loss after the second.
5. A trader buys goods for \$5000, paying import duty of \$400 and carriage inwards of \$250. Delivering them to customers costs \$300, and storing them before sale costs \$150. (a) Calculate the cost of the goods under IAS 2. (b) They will now sell for only \$5500, with selling costs of \$200. At what value are they shown?

Answers

1. Fair value less costs to sell = $15\,000 - 800 = 14\,200$. Recoverable amount = the higher of \$14 200 and \$16 500 = \$16 500. Impairment loss = $18\,000 - 16\,500 = 1\,500$.
2. (a) Adjusting: it shows the inventory's NRV was below cost at the year end. (b) Non-adjusting: the shares did not exist at the year end (disclose if material). (c) Non-adjusting: there was no obligation at the year end, so it is not a liability; it is disclosed in a note.
3. (a) A contingent liability: the outflow is possible, not probable, so it is disclosed in a note and nothing is recorded. (b) A provision: all three conditions are met, so \$50 000 is charged as an expense and shown as a liability.
4. Revaluation reserve = $320\,000 - 250\,000 = 70\,000$. The fall is $320\,000 - 230\,000 = 90\,000$: \$70 000 is set against the reserve, and $90\,000 - 70\,000 = 20\,000$ is an expense.
5. (a) Cost = $5\,000 + 400 + 250 = 5\,650$ (delivery to customers and storage are not part of cost). (b) NRV = $5\,500 - 200 = 5\,300$, which is below cost, so they are shown at \$5300.

Past questions to try

- **9706/34/M/J/21 Q3**: fair value, value in use, impairment, a fire after the year end, and audit reports.
- **9706/33/O/N/21 Q4**: recoverable amount, an adjusting event, a revaluation reserve and capitalising development costs.
- **9706/33/M/J/22 Q2**: a revised statement of financial position, then IAS 37 and IAS 10 definitions.
- **9706/32/M/J/22 Q2**: naming IAS 8 and IAS 2 and explaining the treatment.