Management and financial accounting in practice

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Miskolc

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What is on the agenda for today?

	MIN	Start	End
Principles of management accounting and financial accounting (IFRS) in practice	**30**	10:00	10:30
Management accounting in IFRS annual reports	**30**	10:30	11:00
Performance management and accounting	**90**	11:00	12:30

Principles of management accounting and financial accounting (IFRS) in practice

RECAP!

	Management accounting	Financial accounting
Information mainly produced for	Internal use: e.g. managers and employees	External use: e.g. shareholders, creditors, lenders, banks, government.
Purpose of information	To aid planning, controlling and decision making	To record the financial performance in a period and the financial position at the end of that period.
Legal requirements	None	Limited companies must produce financial accounts.
Formats	Management decide on the information they require and the most useful way of presenting it	Format and content of financial accounts intending to give a true and fair view should follow accounting standards and company law.
Nature of information	Financial and non-financial.	Mostly financial.
Time period	Historical and forward-looking.	Mainly an historical record.

Source: ACCA F2 - Kaplan

Failure to comply with the qualities of useful information

Accuracy – overestimating costs may result in a decision not to produce a product which in fact is profitable; on the other hand, overestimating the price at which the output can be sold (and in general, estimating revenues accurately is more difficult than estimating costs accurately) may result in the organisation – producing output which cannot be sold profitably.

Timeliness – in connection with a decision to close a division or department if the information is presented to management after a decision had been made to lay off staff that could have been profitably employed in other divisions or activities, the company has incurred unnecessary redundancy costs, lost possible future revenues and demotivated the remaining employees when they learn of the redundancies.

Understandable – excessive focus by management accountants on more complex techniques of which general management have little or no knowledge or understanding may mean that the accountant's advice will be ignored. There is currently significant attention being given to the role of the management accountant as an educator within the organisation – explaining the information and training general management to help them to understand the information better.

Example – financial statements

Example – management report?

Difference? Why?

Mobile Service Revenue
Mobile Customer Revenue
Mobile Incoming revenue
Other service revenue
Fixed Line and Carrier Revenue
Service revenue
Mobile intercomnect costs
Fixed Line and Carrier Interconnection Costs
Fixed Line Ongoing Access Costs
Interconnection and Access Costs
Gross margin
Other Non Service Revenue
Other Equipment Revenue
A&R revenue
Total revenue
Direct Costs
Direct margin
Direct margin %
Sales Variable Costs
Sales Fixed Costs (incl. Shared Operations)

Financial accounting considerations

Problems with comparability in FSs

- Line items
- Format (P&L by function vs. Nature)
- Classification (especially in P&L)
- Industry specific topics

Solution! (?): **DISCLOSURES**!

Effect of accounting policies

- Accounting policy vs. Accounting estimate
- Accounting policy:
    - Fair values
    - Revenue recognition
    - Judgement!
- Changes in accounting policies?
- BUT Disclosures!

Disclosures for critical judgements

Impairment reviews

IFRS requires management to perform impairment tests annually for indefinite lived assets and for finite lived assets if events or changes in circumstances indicate that their carrying amounts may not be recoverable.

Impairment testing requires management to judge whether the carrying value of assets can be supported by the net present value of future cash flows that they generate. Calculating the net present value of the future cash flows requires assumptions to be made in respect of highly uncertain matters including management's expectations of:

- growth in EBITDA, calculated as adjusted operating profit before depreciation and amortisation;
- timing and amount of future capital expenditure;
- long term growth rates; and
- appropriate discount rates to reflect the risks involved.

Management prepares formal five year forecasts for the Group's operations, which are used to estimate their value in use. In certain developing markets ten year forecasts are used if it is considered that the fifth year of a forecast is not indicative of expected long-term future performance as operations may not have reached maturity.

For operations where five year forecasts are used for the Group's value in use calculations, a long-term growth rate into perpetuity has been determined as the lower of:

- the nominal GDP growth rates for the country of operation; and
- the long-term compound annual growth rate in EBITDA in years six to ten estimated by management.

For operations where ten year forecasts are used for the Group's value in use calculations, a long-term growth rate into perpetuity has been determined as the lower of:

- the nominal GDP growth rates for the country of operation; and
- the compound annual growth rate in EBITDA in years nine to ten of the management plan.

Changing the assumptions selected by management, in particular the discount rate and growth rate assumptions used in the cash flow projections, could significantly affect the Group's impairment evaluation and hence reported assets and profits or losses. Further details, including a sensitivity analysis, are included in note 4 "Impairment losses" to the consolidated financial statements.

Principles in management and financial accounting

- Materiality (group vs. individual + IC transactions)
- Matching principle (and budgeting…)
- Prudence vs. Fair value (+ expected values)
- Timeliness (cost of perfect information)
- Relevance (past performance vs. future estimations)
- Consolidated vs. aggregated information

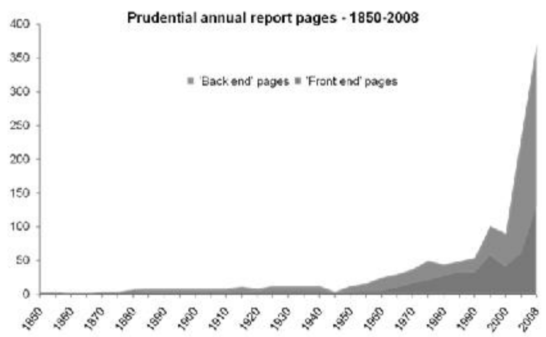
We determined materiality for the Group to be £250 million, which is below 5% of adjusted profit before tax, below 5% of statutory loss before tax and below 1% of equity. Profit before tax has been adjusted for separately disclosed items, notably impairment charges and the trading results of Verizon Wireless prior to its classification as a discontinued operation. We consider this adjusted measure to be a key driver of business value and a focus for shareholders. Materiality is lower than for the year ended 31 March 2013 primarily as a result of the disposal of Verizon Wireless.

The Audit and Risk Committee requested that we include in our audit report all identified unadjusted audit differences in excess of £5 million, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit and Risk Committee on the disclosure matters that we identified when assessing the overall presentation of the financial statements.

Taxation? – Below the line, but significant impact..

The foreign provision for income taxes is based on foreign pre-tax earnings of $47.6 billion, $33.6 billion and $30.5 billion in 2015, 2014 and 2013, respectively. The Company's consolidated financial statements provide for any related tax liability on undistributed earnings that the Company does not intend to be indefinitely reinvested outside the U.S. Substantially all of the Company's undistributed international earnings intended to be indefinitely reinvested in operations outside the U.S. were generated by subsidiaries organized in Ireland, which has a statutory tax rate of 12.5%. As of September 26, 2015, U.S. income taxes have not been provided on a cumulative total of $91.5 billion of such earnings. The amount of unrecognized deferred tax liability related to these temporary differences is estimated to be $30.0 billion.

Management accounting in the financial statements?



Segment reporting

Note 11 – Segment Information and Geographic Data

The Company reports segment information based on the "management" approach. The management approach designates the internal reporting used by management for making decisions and assessing performance as the source of the Company's reportable operating segments.

The Company manages its business primarily on a geographic basis. The Company's reportable operating segments consist of the Americas, Europe, Greater China, Japan and Rest of Asia Pacific. The Americas segment includes both North and South America. The Europe segment includes European countries, as well as India, the Middle East and Africa. The Greater China segment includes China, Hong Kong and Taiwan. The Rest of Asia Pacific segment includes Australia and those Asian countries not included in the Company's other reportable operating segments. Although each reportable operating segment provides similar hardware and software products and similar services, they are managed separately to better align with the location of the Company's customers and distribution partners and the unique market dynamics of each geographic region. The accounting policies of the various segments are the same as those described in Note 1, "Summary of Significant Accounting Policies."

Segment reporting

The Group's segments are reported in a manner consistent with the internal reporting provided to the chief operating decision makers, the members of the Management Committee (MC) of Magyar Telekom Plc. The MC is responsible for allocating resources to, and assessing the performance of, the operating segments on a monthly basis. The accounting policies and measurement principles of the operating segments are very similar to those applied for the Group described in the previous sub notes of the Summary of significant accounting policies. The differences primarily originate from the fact that the operating segments' annual results are determined and closed at an earlier stage, around January 8–10 each year, than these Financial statements. Any items discovered and requiring adjustment between the closing date of the segment results and the approval date of the Financial statements are reflected in the next year's segment results.

The operating segments' revenues include revenues from external customers as well as the internal revenues generated from other segments for telecommunications and system integration/information technology (SI/IT), to a lesser extent, from inter-segment support services. In order to concentrate on real performance achieved on third party transactions, the number of overhead related inter-segment cross-charges applied within the organizations of Magyar Telekom Plc. operating in different segments is fairly limited.

The operating segments' results are monitored by the MC down to EBITDA (Earnings before interest, tax, depreciation and amortization) level, which is defined by the Group as Operating profit without Depreciation and amortization expense.

The MC does not monitor the assets and liabilities at segment level.

Another important KPI monitored at segment level is capital expenditure (Capex), which is determined as the annual investments in PPE and Intangible assets.

Segment reporting

Net sales by product for 2015, 2014 and 2013 are as follows (in millions):

	2015
Net Sales by Product:	
iPhone [1]	$ 155,041
iPad [1]	23,227
Mac [1]	25,471
Services [2]	19,909
Other Products [1][3]	10,067
Total net sales	$ 233,715

Non-GAAP measures in financial statements?

Example- Telco industry

ARPU	Average revenue per user, defined as mobile in-bundle customer revenue plus mobile out-of-bundle customer revenue and mobile incoming revenue divided by average customers.
Capital expenditure ('capex')	This measure includes the aggregate of capitalised property, plant and equipment additions and capitalised software costs.
EBITDA	Operating profit excluding share of results in associates, depreciation and amortisation, gains/losses on the disposal of fixed assets, impairment losses, restructuring costs and other operating income and expense. The Group's definition of EBITDA may not be comparable with similarly titled measures and disclosures by other companies.

Non-GAAP measures

Example

Organic growth

All amounts in this document marked with an "*" represent organic growth which presents performance on a comparable basis, both in terms of merger and acquisition activity and foreign exchange rates. We believe that "organic growth", which is not intended to be a substitute for or superior to reported growth, provides useful and necessary information to investors and other interested parties for the following reasons:

- it provides additional information on underlying growth of the business without the effect of certain factors unrelated to the operating performance of the business;
- it is used for internal performance analysis; and
- it facilitates comparability of underlying growth with other companies, although the term "organic" is not a defined term under IFRS and may not, therefore, be comparable with similarly titled measures reported by other companies.

Reconciliation of organic growth to reported growth is shown where used, or in the table below.

	Management basis					Statutory basis
	Organic change %	Other activity pps	Foreign exchange pps	Reported change %	Presentation adjustments pps	Reported change %
31 March 2014						
Group						
Revenue	(3.5)	3.7	(2.1)	(1.9)	2.7	0.8
Service revenue	(4.3)	3.8	(1.9)	(2.4)	2.9	0.5
Other revenue	4.9	2.7	(4.1)	3.5	0.2	3.7
EBITDA	(7.6)	3.8	(1.6)	(5.4)	2.1	(3.3)
Adjusted operating profit	(9.4)	(27.2)	(0.8)	(37.4)	14.5	(22.9)

Other measures- Exceptional items

4. EXCEPTIONAL ITEMS

Accounting policies
IAS 1 (Revised) – Presentation of financial statements requires material items of income and expense to be disclosed separately.

Critical accounting estimates and judgements
Exceptional items are those that in management's judgement need to be disclosed by virtue of their size or nature. Such items are included within the income statement caption to which they relate, and are separately disclosed in the notes to the consolidated financial statements.

	2013 £ million	2014 £ million	2015 £ million
Items included in operating profit			
Restructuring			
Global efficiency programme (a)	(47)	(98)	–
Supply excellence review (b)	(35)	(95)	(73)
Irish Brewing operations (c)	–	(30)	(30)
Global Supply operations	–	–	(8)
Other			
Korea settlement (d)	(146)	–	–
Associate impairment (e)	(41)	–	–
Brand and tangible asset impairment (f)	–	(260)	(50)
Pension changes – past service credits	–	–	20
	(269)	(427)	(95)

(c) Exceptional items

Exceptional items are those which, in management's judgement, need to be disclosed by virtue of their size or incidence in order for the user to obtain a proper understanding of the financial information. Such items are included within the income statement caption to which they relate but are excluded from the organic movement calculations.

Connection between management and financial accounting

We believe that the management basis metrics, which are not intended to be a substitute for or superior to, our reported metrics, provide useful and necessary information to investors and other interested parties as they are used internally for performance analysis and resource allocation purposes of the operations where we have control or joint control. A reconciliation of the key operating metrics on a management basis to the statutory results are summarised below and provided in detail in note 2 "Segmental analysis" to the consolidated financial statements.

	2014				Restated 2013			
	Management basis £m	Presentation adjustments £m	Discontinued operations £m	Statutory basis £m	Management basis £m	Presentation adjustments £m	Discontinued operations £m	Statutory basis £m
Revenue	43,614	(5,270)	–	38,346	44,445	(6,404)	–	38,041
EBITDA	12,831	(1,747)	–	11,084	13,566	(2,100)	–	11,466
Depreciation and amortisation	(8,981)	1,083	–	(7,098)	(7,543)	1,041	–	(6,502)
Share of results in associates and joint ventures	3,224	269	(3,169)	324	6,354	572	(6,500)	426
Adjusted operating profit	7,074	(395)	(3,169)	4,310	12,377	(487)	(6,500)	5,390
Impairment loss				(6,600)				(7,700)
Restructuring costs				(355)				(311)
Amortisation of acquired customer base and brand intangible assets				(551)				(249)
Other income and expense				(717)				468
Operating loss				(3,913)				(2,202)
Non-operating income and expense				(149)				10
Investment income and financing costs				(1,208)				(1,291)
Income tax credit/(expense)				16,582				(476)
Profit for the financial year from discontinued activities				48,108				4,616
Profit for the financial year				59,420				657

Connection between management and financial accounting

Cash flow measures

In presenting and discussing our reported results, free cash flow and operating free cash flow are calculated and presented even though these measures are not recognised within IFRS. We believe that it is both useful and necessary to communicate free cash flow to investors and other interested parties, for the following reasons:

- free cash flow allows us and external parties to evaluate our liquidity and the cash generated by our operations. Free cash flow does not include payments for licences and spectrum included within intangible assets, items determined independently of the ongoing business, such as the level of dividends, and items which are deemed discretionary, such as cash flows relating to acquisitions and disposals or financing activities. In addition, it does not necessarily reflect the amounts which we have an obligation to incur. However, it does reflect the cash available for such discretionary activities, to strengthen the consolidated statement of financial position or to provide returns to shareholders in the form of dividends or share purchases;
- free cash flow facilitates comparability of results with other companies although our measure of free cash flow may not be directly comparable to similarly titled measures used by other companies;
- these measures are used by management for planning, reporting and incentive purposes; and
- these measures are useful in connection with discussion with the investment analyst community and debt rating agencies.

A reconciliation of cash generated by operations, the closest equivalent GAAP measure, to operating free cash flow and free cash flow is provided below:

	2014			Restated 2013		
	Management basis £m	Presentation adjustments £m	Statutory basis £m	Management basis £m	Presentation adjustments £m	Statutory basis £m
Cash generated by operations	13,462	(1,315)	12,147	13,727	(2,234)	11,493
Capital expenditure	(7,102)	789	(6,313)	(6,266)	974	(5,292)
Working capital movement in respect of capital expenditure	411	45	456	71	3	74
Disposal of property, plant and equipment	106	(27)	79	153	(48)	105
Operating free cash flow	6,877	(508)	6,369	7,685	(1,305)	6,380
Taxation	(3,547)	98	(3,449)	(2,933)	353	(2,570)
Dividends received from associates	2,810	32	2,842	2,420	712	3,132
Dividends paid to non-controlling shareholders in subsidiaries	(264)	–	(264)	(379)	–	(379)
Interest received and paid	(1,471)	156	(1,315)	(1,185)	127	(1,058)
Free cash flow	4,405	(222)	4,183	5,608	(103)	5,505

Connection between management and financial accounting

Segmental revenue

	Management basis							Statutory basis
	Segment revenue £m	Intra-region revenue £m	Regional revenue £m	Inter-region revenue £m	Group Revenue £m	Presentation adjustments £m	Discontinued operations £m	Revenue £m
31 March 2014								
Germany	8,272	(9)	8,263	(11)	8,252	–	–	8,252
Italy	4,312	(8)	4,304	(1)	4,303	(3,782)	–	521
UK	6,427	(10)	6,417	(3)	6,414	(130)	–	6,285
Spain	3,518	(17)	3,501	(2)	3,499	3	–	3,502
Other Europe	5,525	(13)	5,512	(4)	5,508	136	–	5,644
Europe	28,054	(57)	27,997	(21)	27,976	(3,774)	–	24,202
India	4,394	–	4,394	(3)	4,391	(449)	–	3,942
Vodacom	4,718	–	4,718	–	4,718	–	–	4,718
Other AMAP	5,860	(1)	5,859	(12)	5,847	(1,047)	–	4,800
AMAP	14,972	(1)	14,971	(15)	14,956	(1,496)	–	13,460
Non-Controlled Interests and Common Functions	686	–	686	(2)	684	–	–	684
Group	43,712	(58)	43,654	(38)	43,616	(5,270)	–	38,346

Future(?) trends in financial reporting?

- Business modell (e.g. SPPI in IFRS 9)
- Coherence between principles and standards
- Substance over form
- Elimination not recognized transactions (e.g lease, impairment)
- Integrated reporting
- Strategic reporting
- More focus on basic cocepts (e.g materiality)

Impact of future standards? Example- leasing

Industry	Average increase in interest-bearing debt	% of Companies with over 25% increase	Average increase in Gearing (percentage points)
All companies	**58%**	**24%**	**13**
Retail and Trade	213%	71%	64
Professional Services	158%	52%	27
Accommodation & Food Services	101%	41%	18
Transport & Warehousing	95%	38%	31
Construction	68%	20%	8
Manufacturing	50%	21%	9
Financial services	27%	11%	6

Final objective (?) - integrated reporting

- IR demonstrates the **linkages between** an organization's **strategy, governance and financial performance and** the **social, environmental and economic context** within which it operates
- IR can help business to take **more sustainable decisions** and **enable investors** and other stakeholders to understand how an organization is really performing
- Integrated Report = a **single** report which is the organization's **primary report** – in most jurisdictions the Annual Report or equivalent
- each element of an Integrated Report should provide insights into an organisation's **current and future performance**.
- by **addressing the material issues** for an organisation, an Integrated Report should **demonstrate** organisation's **ability to create and sustain value in the short, medium and longer term**.

New era of FS

Example

Financial and non-financial measures

Financial and non-financial measures

Pro forma financial statements

	Group as at 30 September 2014	Adjustment – net proceeds from the Global Offer	Adjustment – Convertible Debt	Unaudited Pro forma total
	(€000)	(€000)	(€000)	(€000)
	(Note (1))	(Note (2))	(Note (3))	(Notes (4 and 5))
ASSETS				
Non-current assets				
Property, plant and equipment	204,889	–	–	204,889
Intangible assets	3,219	–	–	3,219
Restricted cash	49,712	–	–	49,712
Deferred interest	7,931	–	–	7,931
Trade and other receivables	62,230	–	–	62,230
	327,981	–	–	327,981
Current assets				
Inventories	6,395	–	–	6,395
Trade and other receivables	81,342	(2,322)	–	79,020
Derivative financial instruments	15,239	–	–	15,239
Deferred interest	1,144	–	–	1,144
Restricted cash	4,330	–	–	4,330
Cash and cash equivalents	340,383	144,608	–	484,991
Financial assets available for sale	967	–	–	967
	449,800	142,286	–	592,086

Performance management

Purpose of performance management?

- setting a target for performance
- motivating the managers responsible to achieve those targets
- holding these managers accountable for actual performance
- perhaps rewarding managers for good performance and criticising them for poor performance.

Problems?

Be S.M.A.R.T.!

S – Specific: Is the goal explained with enough detail that it can be well understood by those involved in its completion and by any stakeholders?
M – Measurable: How will those involved in completing the goal know it has been accomplished and how will stakeholders determine its success?
A – Attainable: Is the goal attainable or feasible given the resources available?
R – Relevant: Does the goal align with, support, or advance the organization's vision, mission, values, principles, and strategies?
T – Time bound: Does the goal have a target date for completion?

Controllability

The materials purchasing manager is assessed on:

- total material expenditure for the organisation
- the cost of introducing safety measures, regarding the standard and the quality of materials, in accordance with revised government legislation
- a notional rental cost, allocated by head office, for the material storage area.

Required:

Discuss whether these costs are controllable by the manager and if they should be used to appraise the manager.

Financial measures - Ratio analysis

- Liquidity
- Profitability
- Risk

Profitability ratios

- Gross profit margin
- Net profit margin
- ROCE (return on capital employed)
  - capital employed = total assets less current liabilities or total equity plus long term debt
  - ROCE = net profit margin × asset turnover
- Asset turnover

Example

Companies X and Y are both involved in retailing.

Relevant information for the year ended 30 September 20X5 was as follows:

	X	Y
	\$000	\$000
Sales revenue	50,000	200,000
Profit before tax	10,000	10,000
Capital employed	50,000	50,000

Required:

Prepare the following ratios for both companies and comment on the results:

(a) ROCE

(b) profit margin

(c) asset turnover.

Solution

Solution

	X	Y
ROCE	$\frac{10,000}{50,000} \times 100\%$ = 20%	$\frac{10,000}{50,000} \times 100\%$ = 20%
Profit margin	$\frac{10,000}{50,000} \times 100\%$ = 20%	$\frac{10,000}{200,000} \times 100\%$ = 5%
Asset turnover	$\frac{10,000}{50,000}$ = 1	$\frac{200,000}{50,000}$ = 4

Liquidity ratios

- Current ratio
- Acid ratio
- Inventory holding period
- Receivables collection period
- Payables period

Example

Calculate the liquidity and working capital ratios for P for the year ended 31 December 20X9.

	\$m
Sales revenue	1,867.5
Gross profit	489.3
Inventory	147.9
Trade receivables	393.4
Trade payables	275.1
Cash	53.8
Short-term investments	6.2
Other current liabilities	284.3

Measuring risks

- Financial gearing
- Interest cover
- Dividend cover
- Operational gearing?

Issues with financial ratios

- Short termism
- Manipulaiton of results
- Use of only financial measures (do not see the full picture)
- Effect of different accounting policies

Some problems with ROCE

- Managers may focus on generating shortterm profit at the expense of longterm profit. For example, managers may reduce expenditure on training, research and development and maintenance.
- The ROCE will improve if the capital employed figure falls. Managers may therefore be reluctant to invest in new assets.
- Yearend results may be manipulated to improve ROCE. For example, managers may delay payments to creditors or stock purchases.
- Managers may focus their attention on financial performance and neglect non financial performance such as quality and customer service. This may improve pofit in the shortterm but lead to a longterm decline in profitability.

Different aspects of performance

Performance Dimension (goal)	Examples of standards (measures)
Competitive performance.	Market share. Sales growth. Customer base.
Financial performance.	Profitability. Liquidity. Risk
Quality of service.	Reliability. Responsiveness. Competence.
Flexibility.	Volume flexibility. Delivery speed.
Resource utilisation.	Productivity. Efficiency.
Innovation.	Ability to innovate. Performance of the innovations.

Non-financial performance indicators Balanced score card

Customer – what is it about us that new and existing customers value?

Internal – what processes must we excel at to achieve our financial and customer objectives?

Innovation and learning – how can we continue to improve and create future value?

Financial – how do we create value for our shareholders?

Within each of these perspectives a company should seek to identify a series of goals and measures.

Balanced scorecard – Pros and Cons

Benefits of the balanced scorecard:

- It focuses on factors, including nonfinancial ones, which will enable a company to succeed in the longterm.
- It provides external as well as internal information.

Problems with the balanced scorecard:

• The selection of measures can be difficult. For example, how should the company measure innovation?

• Obtaining information can be difficult. For example, obtaining feedback from customers can prove difficult.

• Information overload due to the large number of measures that may be chosen.

• Conflict between measures. For example, profitability may increase in the shortterm through a reduction in expenditure on staff training.