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Accounting Theory

1. Listing Rules
2. The Code of Ethics
3. IAS 41 - Agriculture
4. IAS 38 - Intangibles
5. GAPSME

Chapter 1 – Listing Rules

What are the listing rules?

They apply to those companies that are listed or quoted on the Malta stock exchange. These companies not only need to follow IFR's and the Companies Act but they need to follow an additional set of rules and these are the **listing rules**.

Chapter 5 of the Listing Rules

This deals with the continuing obligations that each and every listed company has to abide with year in year out on a continuous basis. At the end of chapter 5 there is an appendix, this appendix is an integral part of this chapter this appendix has a number of principles that listed companies are encouraged to abide with and these principles mainly deal on how a company should be run on a good and transparent manner. The annex of this chapter is named the code of principles for good corporate governance.

What is Good Corporate Governance?

Good corporate governance is the way a company should be run in a transparent manner do not discount the appendix because each and every company has to prepare a report by that is done by the Auditor and it explains how the company has abided with the principles in the code and whereby the company has not abided it has to disclose the fact why it was not abided, reasons why and how it contends to rectify the situation in the economic future.

Why do you think that listed companies need to follow additional rules?

When you have a listed company there will be more than one shareholder, there will be a number of shareholders, that have invested in that company and each and every shareholder will hold a small amount of shares and there will be a substantial amount of shareholders. The company will not be run by the shareholders themselves but the shareholders will appoint the directors to run the company on their behalf. Therefore the shareholders are trusting their money with the directors who are running the company the directors who are taking decisions that will affect the profitability of the company.

Compare and contrast this with the management and shareholding of a private limited company.

Usually in these types of company are the same as the management so the owners will be heavily involved in the day to day running of the company. Therefore in this case the owners will be taking decisions that will affect the profitability of the company so the owners will know exactly what is happening inside the company and they have full control of the company. If you look at listed companies here there are a number of shareholders and the shareholders are not the directors of the company so they do not have control of what is happening inside the company. The shareholders are not taking the decisions that will affect the profitability of the company. So in this case we have what we call the **principle agency theory**.

What is the Principle Agency Theory?

The principle is the shareholder, the agent is the director so the principle will appoint the agent to run the company on its behalf. Sometimes the agent, the director who does not own the company can take certain decisions that might not be beneficial for the shareholder in the long run.

Example: There is an opportunity for the company to start developing a new product in the first years because the product will still be in its infancy the company is expected to make a loss however after 4 years this product is expected to be hugely profitable. However the agents, the directors will decide? They will say that in the first years the product will make a loss so the bonuses will not be high and the directors don't know whether we will still be in the company in 4 years. They will say its better not to invest in this product even though in the long term it is hugely profitable for the company. So the directors/managers not to lose the bonuses they will not invest in this new product although in the long term it is hugely profitable. There will be conflicts between the principal and agent, the persons who invested in the company and who are actually running the company. That's why we have additional rules to protect the investors from the conflicts that may arise between the principle and the agent between the shareholders and the directors of the company. That's is why we also have an appendix for **Chapter 5: The Code of Principles of Good Cooperate Governance**. Theoretically if a company abides with this code it means that the agents/ directors have run the company in a good way, efficient, effective and proper manner. So they are disclosing in the report that is attached to the financial statements the agents disclose to the principals, look this is what we carried out during this year and this is done to give further info, further comfort to those investors that invested their hard earned cash into that company.

What types of companies are listed on the stock exchange?

1. **Public companies** that offers their shares to the public we call them equity listing companies. Most of the companies that are listed on the companies stock exchange are listed companies like Middle Sea, Farsons. The companies issues the shares the public buys the shares, there is a piece of paper that shows that I own

the shares in return I give the money that I bought the share. As a shareholder you can sell the shares on the stock exchange. The company will not be involved in the transfer of shares between one shareholder and another is a **private transfer** the company will not be involved. Then the new owner of the shares they communicate with the company that they are the new shareholder.

2. **Bonds** a company can also list its bonds on the stock exchange so there are instances where a company will not have its shares listed on the stock exchange but its bonds will be listed on the stock exchange it will still be considered a listed company. What is the difference between equity and bonds? Equity you own part of the company and bonds are loans. Even the interest need to be paid year in year out. Company issue bonds I buy the bonds and I will have a certificate that I own the bonds and in return I will lend the money. Unlike equity bonds have a maturity date and on maturity date the company will have to pay back the money to the bond holders and once the company pays the money to the bond holders, the bonds will seas to exist and the listing will stop sease because the bonds will be paid back. With equity you don't have a maturity date you have an indefinite life. So unless the company buys back its shares that company will remain listed forever.

3. **Collective Investment Scheme (CIS)** What are the CIS? These are referred to as funds and these are companies that they invest in other companies' equity and other companies equity bonds.
   Example: the APS SICAV fund. What happens here is that people invest in the SICAV and people are going to buy one unit each in this fund the shares in this funds is called a unit in that investment scheme. Therefore, I am going to get a certificate that I have a unit in that fund and in return I will earn money because I purchased such unit. Gather a lot of money from the people that invested in the fund and the fund will go and invest the money that it has obtained in other companies shares/bonds example Middle Sea, Apple, Farsons. So you could be said to be **indirectly investing** in Middle Sea, Farsons because you have invested in a company that owns shares and bonds in other companies so you do don't own them directly but through the fund. The value of the fund will increase or decrease depending on weather the assets in which the fund has invested increase or decrease. If the shares of apple decreases the value of the fund will also decrease.

So when we speak of listed companies we will be referring to these three types of lists companies. The listing rules applies for all these three so we do not limit to equity listed companies only.

On each stock exchange including the Maltese stock exchange. There will be two types of listings.

1. A company can list on the main listing or else

2. A company can list on the secondary listing. The secondary listing on the Malta stock exchange is called the alternative market. The secondary listing applies to all the equity and the bonds.

What is the difference between the primary listing and the secondary listing?

A company is admitted to listing on the secondary market when there is not a lot of history about it.

- It has been incorporated three years ago and now it is trying to list. We do not have a lot of background lack of experience the company.
- The amount of capital the company wants to raise is not a significant amount so the company will say I don't want to raise a lot of capital unlike other companies and I am okay to be listed on the alternative market.
- The third reason is when a company does not intend to raise capital on a frequent basis example it might think that it only needs to raise capital once in 10/20 years so the company might say that the company is okay that they will be admitted to secondary listing.

The difference is because the companies that are listed on the alternative market are risker than the companies that are listed on the main market as they will not have a significant track record. The listing rules have a specific chapter on the requirements of a company that is listed on the secondary market which requirements are not as difficult as those requirements for those companies listed on the main market.

Chapter 5 - The continuing obligations

A listed company will have to approve and make public on a yearly basis once each every year an annual report and such annual report will have to be made available within 4 months from the year end. So, if their year end is 31st December the annual report will have to be approved and made available by the 30th April of next year.
Example: 31st December 2017 is the year end 4 months after that is 30th April 2018. So, a listed company will have to publish the annual report on 30th April 4 months later.

Compare and contrast with a private limited company with a public listed company.
A private limited company has up to 10 months for the directors to approve the financial statements and another 42 days to publish to the registrar such financial statements. So, private if yearend is 31st December 2017 the directors have till 31st October 2018 to approve plus 42 other days, so 12th December 2018 to make available such financial statements while in a listed company are much shorter.

This is because in a listed company there will be a number of small shareholders and the shareholders will not be running the business they will appoint the directors who will run the business on their behalf. Shareholders need financial information so that they can take decisions weather to invest or not to lend money or otherwise to the

company. Therefore, it is imperative that listed companies speed up the information that is to be presented to the shareholders. That is why listed companies have 4 months to provide financial information to ensure that information is provided as soon as possible, to the shareholders and to the users of the financial statements. In a private limited company there is no need to rush because in a private limited company the owners will be the same as the managers, the shareholders will be running the company day to day they will know what is happening no need for information to be given as soon as possible to make decisions.

IMP: What are the components of an annual report?

An annual report should comprise of the following items:

- A full set of financial statements that are prepared in accordance with IFRS's. Malta is a member in EU, so any company listed on the Maltese stock exchange have to prepare financial statements according to the IFRS. A private limited company unlike am public listed company has the option to prepare financial statements either with IFRS or GAPSME. Listed companies don't have such option listed companies have to prepare financial statements according to the IFRS as adopted by the EU. They will state it out loud in the first note of the financial statements there will be a note called basis of preparation and in such note the first sentence will read as follows:
  'These financial statements have been prepared in accordance with international financial reporting standards as adopted by the EU.' (IMP: Difference between a public listed company and a private limited company)

- The auditor's report to the financial statements. All financial statements here in Malta will have to be audited, irrespective whether it is a private limited company or a public listed company. So an audit report to the financial statements is a common aspect for both a listed company and a non-listed company. Each company will have to be audited by an auditor.

- The directors report the requirement to have a directors report does not come out of the listing rules. The requirement to have a director's report comes from the companies act article 177. That each and every company will have to prepare a directors report and it is the same for a public listed company they have to prepare a directors report but the listing rules go one step further they state that the directors report of a listed company will need to have more information then the directors report of a non-listed company.
  Additional three requirements that there should be in the director's report. The director's report of a listed company should have all the requirement mandated by the companies act plus the additional requirements required by the listing rules. These three are:

1. To disclose who owns more than 5% of the shares in that company and is a director of that company as well. When we say own we mean **directly owned** and **indirectly owned**. The difference between directly and indirectly owned.

   Example of directly owned by the company: A director of the company owns Garden plc. which is a listed company. A (individual) the shareholder owns directly 5% of Gardens plc. shares. A (individual) has a direct investment in Garden plc.
   Example of indirectly owned by the company: A (individual) owns 90% of the shares in B ltd and in return B ltd owns 6% of the shares in Garden plc. A (individual) does not directly own the share in Garden plc. but owns them through B ltd. A (individual) owns them indirectly through B ltd. A (individual) owns more than 50% + 1 of the shares in B ltd. A (individual) control B ltd, so if it controls B ltd, it holds the majority of the shares and B ltd has 5% or more, then A (individual) owns 6% of Garden plc. through B ltd.

   Those individuals who are acting as directors who directly or indirectly owns 5% or more of the shares. In the second example, B limited can never be a director, it is a company, we say A through B limited owns 6% of the shares in Garden plc. We need to disclose this fact because the other shareholders would want to know if there are any directors who own a significant proportion of the shares. Those directors who own a significant proportion of shares , can take decisions that are in their favour but against the interest of the other small shareholders and therefore by disclosing this fact in the directors report everyone will know who of the directors own a significant portion of shares and therefore any decisions taken by such directors will be highly scrutinized and this follows the concept that a listed company has to provide more information than a private company. The company is providing further information so the public can assess the stewardship of the company.

2. When a company will have an employee share scheme this is a scheme whereby the employees will partly be paid in cash whilst the remainder of the wages will be paid with future shares in the company.

   ## How does an employee scheme work?

   An employee earns €4000 per month however the company will not pay the full €4000 in cash the company will pay €3000 in cash and the remaining they will be paid to the employee by future shares. The company will tell the employee that the shares are valued at €1 so I am going to give you 1000 shares which you can take in 2020. So, today the company will give the employee the right to purchase 1000 shares at €1 each in 2020, the company will be issuing an additional 1000 shares which the employee can buy at today's market price €1 in 2020. This employee share scheme is there to provide an incentive to

employees to work more and harder so that they will increase the profitability of the business and when this increase the share price of the company and the share price on the stock exchange will also increase. These employees who have been granting the right, worked hard, the profitability of the company also increases the share price of this company on the stock exchange in 2020 will be €1.45. What does this mean this means that the employee will exercise his right to buy the shares at €1 in 2020 the company will give him the share certificate and at the same time the employee can go on the stock exchange and sell the share for €1.45 earning an instant profit of 45c.

Why does the employee share scheme need to be disclosed?

This effect the shareholders of the company the option to buy shares in the future will affect the current and prospective shareholders of the company. Example: The profit of the company is €500,000 **today** the number of shares in issue are 500 so the earnings per share is €1000 per share. **In 2020** the profit is the same but the number of shares are 1500 shares so €333 per share so here each and every shareholder in 2020 because of this additional right are going to earn less per share and therefore by disclosing this fact in the directors report we are telling the current and potential shareholders the effect such rights will have on the earnings for each and every shareholder. So, the double entry is
Dr Wages and salaries
Cr liabilities

3. When a company has a clause the employment contract of its top management which clause is referred to as the **golden handshake**. The golden handshake is that in the contract there might be written down that if a top manager or a director is fired is sacked he receives a onetime sum of money. It is used abroad for the top executives of the company.

Why should this be disclosed in the director's report?

Shareholders would want to know whether there are any golden handshakes because they are an additional expense for the company the company has to fork out extra money. Therefore, if expenses will increase the profit will go down and if the profit goes down the dividends will go down and shareholders will earn less money so, if there are any golden handshakes these should be disclosed in the director's report.

1. Components of director's report code of principles:

The requirement to have a director's report does not come out from the listing rules it comes from the companies act article 177 what the listing rules mentions is that the directors of a listed company need to have more details than that required from the companies act:

- Those directors who owns 5% or more of the shares have to be listed

- Information about employee shares scheme
- Information about golden handshakes means termination benefits for those top executives

2. Audited Financial Statements

As form 1st January 2005 all companies listed on an EU stock exchange will have to prepare financial statements in accordance with IFRS's if we look at the IFRS's the IAS 1 states that the components of the financial statements are:

- Income statement
- Statement of financial position
- Statement of changes in equity
- Statement of cashflows
- Notes to the accounts

So, in accordance with chapter 5 of the listing rules each and every company has to prepare a full set of financial statements in accordance to IAS 1 and this full set of financial statements will have to be audited by an independent third party (auditor).

3. Auditors report for Financial Statements

s/he will draw up a report that states that the financial statements prepared by the board of directors show a true and fair view or otherwise and this report will be attached to the financial statements.

What is the difference between a listed company and a private limited company?

A private limited company has the option to prepare financial statements either with GAPSME or IFRS. A company that falls within the threshold of small or medium can prepare in accordance with GAPSME a listed company, even though it falls within the criteria if a small or medium company it cannot prepare financial statements in accordance to GAPSME it always has to prepare in accordance with the IFRS as endorsed by the EU and issued by the IASB.

4. Statement of principles for good corporate governance

This statement for good corporate governance is required by chapter 5 the appendix of the listing rules by deduction, the statement of principles is required to be prepared on by listed companies. There is no need for private limited companies to prepare the statement of principles for good corporate governance.

What are these principles?

These should help the directors, management of the company to run the business in a transparent, efficient and effective manner so if a company abides with this code of principles the shareholders will know that the company had been run in an efficient and effective manner.

What is the code?

First Principle in the code has a principle that states that the board of directors should meet on a regular basis therefore in order for the board to be effective it cannot meet once or twice a year it has to meet regularly over the years and that's how a board can be effective. A board is there to take decisions and to set the strategy of the company therefore if the board does not meet regularly they cannot make decision on a timely manner, the company will not be able to have a strategy and that's why it is a principle for good corporate governance because the directors meet on a regular basis. If you read the report that would fall part of the annual report there would be a table with the list of directors. Example:
Mr. Cassar attended 4 meetings
Mr. Borg attended 3 meetings
It shows which directors did not carry out their duties. The shareholder will read the annual report and they will see who attended the meeting so they will see who was interested in attending the meeting and s/he is there for the meeting so the shareholders will decide who to elect depending on who carried out their duties.

The Second principle is the board of directors should be made up of **non-executive directors** and **executive directors**. The difference between these two is that executive directors are directors who are also employed on a full-time basis with the company example the CEO or the CFO they will hold full time positions with the company and they will act as directors of that company therefore the executive directors the main wages and salaries will be derived from their full-time job with the company. Non-executive directors are individuals who are directors of the company but they do not have any full-time position with the company they simply act as a director they come at the company's offices for the board meetings so their main income is not derived from the company now this code of principle states that there should be a mix between executive and non-executive because non-executive directors are conditions to be more independent than executive directors. This is because executive directors receive their main salary from the company therefore executive directors are more likely to take decision that might not be in the best interest if the company in the long term. Non-executive directors do not depend on the company for the main source of income they will surly stop disagree with any decisions that might not be in the best interest of the shareholders. So, when there would be non-executive directors on the board it is a clear indication that decisions are being taken in favor in the long-term interest of the shareholders.

Third principle of the code states that the board alone cannot do all the work and in order for the board to carry out an efficient and effective management of the company it has to be assisted by a number of sub committees that will help the board of directors to run the company therefore the board of directors will delegate work to these sub committees. These sub committees will carry out the work and then they will report back to the board of directors an example of a committee is the remuneration

committee. This is the committee that sets the wages of the top management the board of directors are not going to lose time to set the wages of the top management so the board of directors will meet four to six times a year, the board of directors will delegate this work, to the remuneration committee, the remuneration committee will set and discuss the wages and salaries with top management. Then the remuneration committee will report to the board of directors the outcome of the situation this is done so that the board of directors will be freed up from the bad decisions and therefore the board will focus on the strategic decisions.

The fourth principle is that the code of principles states that a company is making profit derived from the output it provides to society therefore it is only fair that companies should give something back to society and therefore the company should take initiatives to carry out activities corporate social responsibility.

5. Auditors report on the statement of good cooperate governance

   The auditor will need to issue a report saying that the information provided by the company in the statement of good cooperate governance is correct, factually correct so for a listed company there will be two types of auditor's report:

   - On the financial statements
   - The report of the directors on the code of principles of good corporate governance.

The interim report

A Listed company also need to issue an interim report covering the first 6 months of the financial year. This is not a requirement of the companies act it is a requirement of the listing rules so only a listed company will issue an interim financial report. This will be made up of an interim director's report and condensed shortened financial statements for the period covering 6 months. This interim financial report will have to be issued by 2 months after period end. So, if the financial year is 31st December so the company need to issue interim financial report as at 30th June and an annual report as at 31st December. The interim financial report as at 30th June will have to be issued by 2 months after period end so 31st August. The listing rules makes it mandatory for an annual financial report to be audited. However, the listing rules states that an interim financial report does not need to be audited so an interim financial report is up to the option of the company to have it audited or otherwise and if not audited it will have to write down on the financial statements that these interim financial statements are unaudited. When compared to the annual report an interim financial report does not need to have a statement for good cooperate government from the directors and therefore if there is no statement form the good cooperate governance there is no need for the auditor to issue an audit report on the statement of principle of good corporate governance on interim state.

Main components of an interim financial report are that there should be an interim condensed financial statement, interim directors report, no need for the interim financial statements to be audited so it is not mandatory to have the interim financial statements audited so, they can be unaudited. No need to have a statement of compliance on good corporate governance therefore if there is no statement there is no need to have an auditor's report on binding on the contents of such statements of principles. There are a number of differences between an annual report and an interim financial report.

Interim financial report will have an interim condensed financial statement by condensed means shortened financial statement, an abbreviated statement of full financial statement. Do not mistake the condensed financial to the concept of a bridge of the companies act. Condensed financial statements are shortened financial statements issued in accordance with IAS 34 issued by the IASB which deals with interim financial statements. In the first note to the financial statements usually in a full set there will be written down: 'these financial statements have been prepared in accordance to IFRS's as issued by the IASB'. In the very first note of the interim condensed financial statements we have to write down: 'these financial statements have been prepared in accordance with IAS 34 – interim financial report as issued by the IASB'. So, when it comes to prepare interim financial statements the company only need to abide with one standard IAS 34 however, the same company when it is preparing the full financial statements it has to prepare its full financial statements in accordance with all standards issued by the IASB.

Condensed means shortened financial statements so, there will be line items

- Revenue
- Gross Profit
- Operating Profit
- Finance Income and Expense
- Profit Before Tax
- Profit After Tax

In the balance sheet we only show the headers:

- Non-Current Assets
- Current Assets
- Total Assets
- Total Equity and Liabilities
- Non – Current Liabilities
- Current Liabilities

In the statement of cashflows we show:

- Cashflow from operating activities
- Cashflow from investing activities
- Cashflow from financed activities
- Movement in cash and cash equivalents
- Opening in cash and cash equivalents
- Closing cash and cash equivalents

Assume that my financial year covers 1st January 2017 until 31st December 2017. A company will have to issue its interim financial report for the first six months so from 1st January 2017 up till 30th June 2017. So, my income statement in the interim condensed financial statements will cover from 1st January 2017 up till 30th June 2017. Comparative the same six months but of prior year 1st January 2016 up until 30th June 2016. It is the same story for the SOCIE and for the statement of cashflows we show the six months of this year and as comparative we see the six months of prior year.

Balance sheet we issue it at 30th June 2017 thus the comparative is going to be the balance sheet as at 31st December 2016. Balance sheet is a snapshot of the assets and liabilities of the company taking a picture at a particular point in time of the assets and liabilities of the company. That's why I cannot compare the balance sheet of 30th June 2016 because another more recent comparative balance sheet has been issued and with a balance sheet we compare a particular point in time that's why we say as at not yearend. In the notes to the condensed financial statements there will be preparation according to the:

- Preparation of compliance that the financial statements have been prepared in accordance to IAS 34
- Application going concern concept
- No need to disclose all of its accounting policies that means that there is no need for the company to rewrite all the accounting policies which accounting policies can be found in the latest financial statements. What the company writes down is that the company applied the same used in the financial statements and that there were no changes for the first six months of this financial year. If there would be changes the company will state that the accounting policies are the same as last year except for and it discloses such changes and the effect on the financial statements, the company will have to provide IFRS 8 segmental information that will have to disclose any significant purchases or disposal of fixed assets and it will disclosed related party transactions. Only those notes are required in the condensed financial statements. If you had to look at the condensed financial statements in total there will be 8 – 10 pages. Annual financial statements of a listed company will have around 80 – 100 pages and this shows how the condensed financial statements are considered the shorthanded financial statements.

EXAM: Chapter 1

- Listing rules difference and compare from interim report and annual report
- Describe the components of an interim report
- Describe the components of an annual report
- Difference between interim financial statements and annual financial statements

Chapter 2 - Code of Ethics

The code of ethics are rules that are part of the accountancy profession act that should guide an accountant to act in a professional manner. EXAM - It is built on five fundamental principles:

1. **Integrity** – an accountant will have to be straight forward and honest in all professional and business relationships.
   - So, if someone will ask the advice of an accountant whether he or she should invest in company A or in company B and the accountant knows that company A is not doing as well as company B the accountant is expected to tell the person who he is giving advice to that it is better to invest in company B and not in A.
   - That if an accountant is advising on tax matters it is expected that the accountant does not help the client to avoid tax. So, it is expected that the accountant is honest in all dealing with the tax man.
2. **Objectivity** - the account does not allow prejudice or bias to seep (enter) into his/her judgement
   - Lest say that the CFO has shares in the company and the CFO knows that there are a number of debtors that will not be recovered so a provision of impairment and a provision for bad debts have to be made or write bad debts off. If the company is going to provide for these debtors the company will show a loss and the company show a loss the share price of that company will go down and the CFO who owns the shares will lose money because there will be a decrease in the value of the shares. So, the objectivity of the accountant will be impaired because if the CFO will lose money because the company will make a loss and the share pre-will go down. So, it is better not to adjust for the bad debts not to lose any money so the accountant CFO is not thinking straight it is allowing other things that will ultimately impaired judgement as to whether to reflect the provision or otherwise the accountant is being biased. The only reason why he does not want to reflect the increase for provision for bad debts is simple because he will lose money.
   - Where bias would have on the accounts mind let's say Sarah is the CFO of a company and is married to the same company's auditor and he finds a mistake of 1 million. So, the auditor will start thinking that if he if he says the truth he will not be honest with the users and if he doesn't say the truth Sarah (CFO) will be fried. There the objectivity of the mans is impaired, he cannot think clearly because there are one factors making him uneasy. David judgement is biased on one hand he wants and on the other he does not want his wife to lose his job.

3. **Professional Confidence and New Care** – an accountant will always have to ensure that he keeps up to date with laws and regulations that effect the provision in order for the account to provide the best service to his or her clients. So, in order for an account to do a professional job her or she must be an expert in accounting and in order to be an expert one has to learn new standards and new tax laws. That is why the code of ethics on of the fundamental principles says that an accountant needs to keep abreast to of the latest financial developments in order to provide the best service to his/her clients. In facto one of the requirements for an accountant to do 24 hrs each year of training – Continued Professional Education.
4. **Confidentially** – during the course of his or her own work the accountant will have access to certain confidential information if I will be the auditor or an accountant of a listed company I will know before everyone what the profit of that company will be before the results are published. If I am the CFO of that company I will know all these strategies that the company has for the future so I could determine the companies' potential to earn future revenues that an accountant will know all of this information because of his/her position. A third party who is not an accountant will not know this information. So, an accountant will be at an advantage when it comes to sensitive info. That's why the code of ethics is clear it states that an accountant cannot make use of this confidential information before it is made public for his own or her own personal benefit.
    - So, let's say that the accountant knows that the company will report to the public an increase in profit of 2 million euros. The accountant therefore knows that when there will be an increase for profitability the share price will go up so the accountant can say that they can buy the shares now so when the results are made public the share price will go up and I will sell the shares at a higher price than at how much I bought them and make a profit **this cannot be done** because the accountant is making use of **confidential data** for ones benefit. Need to pay attention what to say to third parties
5. **Professional behaviour** – an accountant will have to comply with all the relevant laws and regulations and avoids bringing the profession in disputes, an accountant cannot take bribes or kickbacks, no money laundering, an accountant cannot give advice to clients to avoid taxation and an accountant cannot be thought taking drugs.

The code ethics speaks of an important concept which is <u>independence</u>:

- **Independence of mind** –the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, thereby allowing an individual to act with integrity, and exercise objectivity and professional scepticism.

- **Independence of appearance** – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit or assurance team's, integrity, objectivity or professional scepticism has been compromised.

Difference between independence of mind and independence of appearance

Example imagine I am auditing my father's company so issuing an auditor's report on my father's company I could be the perfect auditor in other words my independence of mind is clear without biased even though it is my father's company - **Independence of mind**

How you are being portrayed by third parties, If I am signing my father's company the third parties will say that even if they carry out the perfect audit he is not carrying an independent appearance because no one will believe him - **Independence of appearance.**

So, an auditor will have to attain independence in both manners in mind and appearance, they both must be satisfied. Now the code of ethics speaks about 5 threats of independence.

1. **Self- interest** – this is when the accountant or the auditor or a close family member of the accountant or auditor holds a financial interest in that company.
   - If accountant has shares in a company and he know that some debtors should be written off, the auditor or accountant might think twice before he adjusts for those debtors that can never be recovered, not only the accountant even his close family members. If accountant has shares in a company and he know that some debtors should be written off, the auditor or accountant might think twice before he adjusts for those debtors that can never be recovered, not only the accountant even his close family members.
   - An accountant would have to choose between two tenders and the company that has submitted tender A will bribe the accountant so that the accountant will choose tender A. here the accountant has a financial interest he is being bribed a kickback so the independence of mind is impaired. That's why the code of ethics has a number of safe guards:
     - an auditor of a company cannot own shares in the company he is auditing, if he does he has to sell such shares before the audit starts
     - An accountant cannot receive kickbacks (bribes) as that will also impair his financial judgements

    - An accountant cannot receive gifts because that will impair the judgement of the auditor.
2. **Self – review** – this is when someone will carry out a piece of work and the same person reviews his or her own project. When someone does this it will be impossible to identify any mistakes because you will be reviewing your own self. That's why the code of ethics is clear that is person prepares the accounts of the company cannot be the same person that audits the company because there will be a self-review trap because they will review their own work. That's why audit firms must have a separate team working on accounting and another on auditing this is to ensure any self-review treat that's why the companies act makes it clear that the board of directors are responsible for the preparation of the financial statements and not the auditor is the one who is responsible for the financial statements. The directors and the management are the ones responsible to prepare the financial statements and the auditor reviews the work carried out by third parties.
3. **Advocacy** – it is important that an auditor does not give advice which advice would come back and haunt him when s/he is doing the audit work that's why audit firms are precluded from providing tax advisory services accounting advisory services and other types of advisory services to audit clients the reason is that if the advisory team advices the client and the auditor will come and tart the audit and the CFO states that they do not agree how they accounted for the transaction and the CFO can turn to the auditor and the advisory team advice my to this it's your fault your different teams are not even agreeing with each other so the safe guard if an audit firm cannot give advice to its audit clients
    - Example: Imagine an audit client will phone the partner and ask the partner, we have incurred millions to develop a pharmaceutical drug, should we expense or capitalise it? Partner says capitalise it. The audit team will dig deep and realise that they should have never expensed it. Such cost should have never been capitalised, shown as an intangible asset and not expensed the advice that the partner gave cane back to haunt the audit team. It will be very difficult to argue the CFO to reverse that transaction.
4. **Familiarity** – excess familiarity can impair the auditor's judgement and that's why the code of ethics makes it mandatory for the audit partner to change each and every 5 years, the audit partner will have to change, now with the new EU legislation the audit firm will have to rotate after 10 years. This is done to ensure that there will not be any familiarity between the auditor and the client. 'Familiarity brings content.'
5. **Intimidation** – an accountant can intimidate the auditor if you reflect this adjustment I will kill you like threating like losing one's job, judgement would be impaired. That why the code of ethics makes it clear that an auditor who feels intimated has the right to resign immediately.

Chapter 3 – IAS 41 – Agriculture

This standard IAS 41 applies for biological assets except for barer plants, it is also applied for agriculture produce.

What is a biological asset?

A living animal or plant it does not only mean an animal but also plants so IAS 41 applies for both. However, IAS 41 applied for biological assets except for barer plants so a biological asset is a living animal or plant.

What is a barer plant?

A **barer plant** is a new concept introduced from 2016 onwards – IAS 41. A barer plant is a living plant that is used in the production or supply of agriculture produce it is expected to barer produce for more than one period and it has a small likely hood that it is sold as agriculture produce. So, IAS 41 does not apply for barer plants it is IAS 16 that applies for it although barer plants are biological assets because they are living plants they are not accounted for IAS 41 they are accounted for in accordance with IAS 16.

Under IAS 41 there is only one measurement mode the fair value model but under the IAS 16 there are two models the cost and revaluation so the barer plant can be seen as cost and fair value. With movement in fair value goes in other comprehensive income. Under IAS 41 any movement in fair value of the biological asset will go directly in the P&L if barer plants are measured with IAS 41 then the income statement will be incorrect because you will be taking the movement directly to the profit or loss when they should be accounted for according to the IAS 16, any movement in fair value should go into the comprehensive income. We said a barer plant is used in the production or supply of agriculture produce. Example: If I have a tree fruits will be hanging from the tree and such tree will be producing such fruits so the barer plant the tree is used to produce fruit.

The standard does not apply to the following:

It is expected to **barer produce** for more than one period, you plant it once and they give you fruits for a number of years. So, the trees will bear fruits over more than one period vs tomato vines once they bear the tomato they die that is natural death they have to be replanted again so they do not produce for more than one period. So, tomato vines are not considered to be bearer plants so they are accounted for in accordance to IAS 41. A lemon tree they barer fruit more than one year so it should be accounted for according to IAS 16 – PPE.

This standard does not apply as well to **land related to agriculture activity**. When agriculture activity is taking place should not be accounted for according to IAS 41 it should be accounted for in accordance to IAS 16. Any intangible assets related to agriculture activity would have to be accounted for under IAS 38 – intangible assets. Example of IAS 38 used in agriculture activity – who owns cows will also milk the cows and this milk is sold to Benna, in order to own cows and take the milk produce to Benna you need to have a permit issued by the agriculture authority. So, I cannot wake up and say I quit as an accountant and start rearing cows I need a permit. That permit is an intangible asset and should be accounted for under the IAS 38.

IAS 41 only applies up to the point where produce is harvested that means that when produce is harvested IAS 41 no longer applies it will be IAS 2 – inventories that will apply. Example I have apple trees they are barer plant apples will grow so until the apples are hanging on the trees such apples will be accounted for in accordance to IAS 41. Once someone picks up the apples so the apples are harvested IAS 41 stops applying and such harvested produce will start to be accounted for in accordance IAS 2 – inventories. This is because when the apples are hanging from the tree they are alive like the definition said 'biological asset is a living animal or plant'. Something that is no longer alive it should not be accounted for under IAS 41 but under IAS 2 – inventories. IAS 41 because of this concept it is very clear that any products that are the result of further processing after harvest they should be accounted for under IAS 2 – inventories. Example dairy cattle is a biological asset because it is composed of a living animal, form the cattle we get milk. The milk is the agriculture produce if such milk is further processed and from that we produce cheese. Although cheese is a derivative of an agriculture produce and a biological asset it will be accounted for IAS 2 not IAS 41. It is the same with pigs it is a biological asset the carcass produce is a harvested produce like sausage and ham they are a derivative of an agriculture produce and a biological asset and they should be accounted for in accordance to IAS 2. We account for something in IAS 41 up to the point of harvest beyond that point IAS 2 will apply.

Another condition that needs to be satisfied in order to recognise the asset under IAS 41 and this is **biological transformation**. Biological transformation comprises the processes of growth degeneration, production and procreation that cause qualitative or quantitative changes in the biological asset. Biological transformation like the way an orange grows, a pig starts from the natural procreation process. For something to be accounted for under IAS 41 there should be biological transformation.

Another condition to be accounted for under IAS 41 there should be **agriculture activity** and this one of the key points is the management of change. This means someone is assisting, helping such biological transformation. So, to be accounted for IAS 41 there should be the management by third party like a farmer. Example if trees

are not watered by a farmer the tree will not bear fruits so a third party is assisting in the management of change. Same if the farmer does not clean the animals shelter the animals will die so need of a farmer. That is why fish farming is considered to be an activity that falls within the definition of IAS 41 because someone is managing the change we are feeding the plants, administrating medicine for the fish which may be sick. Compare and contrast this with fishing in the open seas this does not fall under IAS 41 because fish in the open seas they are not being taken care of by third parties, no one is managing the change or feeding them.

Measurement of IAS 41

Imp: Once we decide something falls within the scope of IAS 41 it is time to measure such biological asset. This is measured by upon initial recognition and at the end not at the initial recognition of a biological asset which should be measured at fair value less costs to sell. Cost to sell need to estimate the selling cost in order to incur the asset. So, at initial recognition and each and every financial year the biological asset should be measured at fair value less cost to sell. Any movement in fair value between one reporting period and the next have to be accounted for directly in the income statement (P&L).

Example if I had a cow as at 31st December 2016 and its fair value cost to sell is 500 euros and has grown during 2017 and at the end of 31st December of 2017 the fair value less cost to sell is 800 euros the movement in fair value should be accounted for in the income statement movement of 300 euros

Dr biological asset 300 euros

Cr movement in fair value income statement of 300 euros

Why are movements for something to be accounted under IAS 41 there should be measurement of change when I give example a nutrient to the animal I am incurring a cost and such costs are expensed to the profit and loss so to manage change I am incurring expenses. Any increase in fair value because of the management change should be accounted for in the P&L in order to match revenue with expenses. Its only fair to match revenue with expenses.

The standard makes it also very clear that it starts showing an asset at fair value you cannot say the market disappears and say because the market disappeared I will start valuing the biological asset at cost. Once you start to measure an asset at fair value less cost to sell you have to continue measuring with it. Thus, this standard does take into consideration that there are instances where a biological asset might be so rare that there will be no market for it. So, upon initial recognition it might be difficult to arrive at its fair value less cost to sell. Now the standard says that in these circumstances where at fair value cannot be measured properly the biological asset

can be measured at cost and its cost depreciated over the useful life of an asset. However, the standard also makes it clear when a market appears and a company determines that there is an active market, constant buying and selling of that biological asset the company has to switch immediately from the cost model to the fair value less cost to sell. It cannot be the other way around a company can never switch from the fair value to the cost model. The fair value might be very difficult to obtain. Example going to a zoo some reptiles are very rare to find and because of this there will not be an active market of buying and selling of this biological market. When a market does not exist, the biological asset is measured at cost less depreciation. If it is an active market it is at fair value less cost to sell no depreciation.

EXAM: conditions to be accounted for under IAS 41

Chapter 4 – IAS 38

What are intangible assets?

Paragraph gives the definition as: **"An intangible asset is an identifiable[3] non-monetary[2] asset without physical substance[1]."**

Explanation:

1. **Physical substance** – This represents the main difference between a tangible and intangible asset. An intangible asset does not have physical substance meaning you cannot touch it.
2. **Non-monetary** – It is not part of cash and cash equivalents. One could argue that money held at a bank account you cannot touch and neither smell it. You just see a number on a computer screen. So, cash and cash equivalent, unless it is cash in hand, they do not have any physical substance. So, in order to an asset no to fall within the definition of an intangible asset refers to something being non-monetary, meaning being something not related to cash and cash equivalents.
3. **Identifiable** – In order to understand the definition of identifiable you need to go to paragraph 12 of the standard. An asset is an identifiable if either is separable meaning capable of being separated from the entity and sold either individually or together with other identifiable assets or it arises from contractual or other legal rights. For identifiable to be attained there is no need to maintain both conditions but one condition is enough.
   - **Legal Right** - An intangible can be a trademark, an acquired bank, a licence to operate in a particular market, where the entry to such parties is limited to a number of players.

     For example, if I want to open a radio station or to run a TV station, I just cannot click my finger and start an operating a radio station but I need a licence from the competent authority. That license cost money and it is not provided to each and every one that apply for that licence. So that license is an intangible asset.

     If I want to setup a taxi company by such having cars but I need a license to operate. That costs money as well. For a license to be transferred from one party to another it costs money. The rural farmers that rear cows for milk, they also have a licence.

     No everyone can sell milk to Benna. They need a specific license by the agriculture authority. That licence can cost millions.

     There is a contractual agreement between the company and the Malta communications authority where the Malta communication authority is giving a legal right to the company to operate a radio/TV station.

Example the Transport Malta is providing a legal right to the taxi company to operate taxis within that area.

A patent is also an intangible asset. When I patent a product I will be registering such patent with the relevant authorities meaning that no one can copy my product. It is only I tat I can produce that product. If someone copies that product I can take him to court to seek damages.

Another example is Coca Cola they must be registered with the competent authorities. Automatically when there is a contractual or legal right, an asset is considered to be identifiable.

- **Separability** - This means that an intangible asset can be sold either individually or with a group of assets without having to sell the business as a whole. If I have invented a formula for glue that is superlative to any glue that exists on the market, I need to understand whether I should recognise the cost of developing such glue as an intangible asset. The reasoning should immediately go to the definition of an intangible asset. We need to ask "Thus this meet the definition of an intangible asset?" The recipe does not have a physical substance. We are not going to recognise the glue but the recipe behind that glue. The recipe cannot be smelled or touched therefore it cannot be considered as an intangible asset. Is it identifiable? We have no indication whether the recipe is has been patent. So, in the absence of a patent, the 2nd condition of legal right is not met. Can it be sold separately; can I sell the formula to someone else? Most probably the answer is yes because I can see the formula without having to sell the whole business. It can be separated from the business as a whole. In that case since there is no patent and no legal right, it is considered as identifiable because it can be separated meaning it can be sold separately. In all we can say it is an intangible asset because it meets the 3 characteristics.

As you may know the name of Coco Cola has a trademark on it. However, the recipe to produce Coca-Cola is not patented. Only a handful of people about the recipe, the content of such recipe and is well stored in a place in the US. Here I may be looking at 2 types of intangibles. 1st I have the trademark and 2nd I have the secret recipe of how Coca-cola is produced.

1. Trademark – there is a legal right that no one can make use of the name Coca-Cola, so there is a legal or contractual right. I can capitalize a trademark of the intangible asset.
2. The recipe - Can I capitalize the recipe? So, we said that it is unpatented so the 2nd criteria of identifiability cannot be met. The question is "Can the recipe be sold separately?" One could argue that the recipe cannot be shown as an intangible

because it cannot be separated from another intangible which is the trademark. The standard states that it either is sold separately and either with other identifiable assets. So, the recipe can be sold with trademark of Coca-Cola. So, we conclude that both the trademark and the recipe can be recognised as an intangible asset.

An intangible has to meet the definition of the asset as per framework. Paragraphs 13 and 16 deals with the notion of control of the asset. For something to be recognised as an intangible asset, the company must have control which is a key point in the definition of the asset. The standard says:

""The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law."

"In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way."

Let us take employees: A company needs employees, it generates its revenues party from its employees particularly if it is a service company. Workers have knowledge. The question is that "should the knowledge of the employees be capitalized as an intangible asset?" The knowledge of the employees has no physical substance and I cannot touch or smell it. Is it monetary? No, it is not cash and cash equivalents. Is it identifiable? There might be a legal right. When the employees leave, the company would not close down. It is impossible to transfer the knowledge from one person to another. It is very difficult to control such knowledge.

Football players - should football clubs recognise as an intangible? You recognise the skills of the players. The skills are monetary? No, since if a player wants to leave, once the contract runs out he can leave. So, the skills of a football player cannot be controlled. Why do football players have a huge intangible asset on their balance sheet? Footballs do not capitalize the skills of a football player, but they capitalize the contract. The contract is an intangible asset.

Chapter 5 – GAPSME

GAPSME is the accounting framework for small and medium enterprises. Small and medium enterprises shall apply GAPSME when preparing financial statements. So, for those companies that meet the criteria of GAPSME, they should make use of GAPSME, so it is the default gap for small and medium enterprises. Any company which is small or medium, that means it meets the definition of small and medium, but it does not want to apply GAPSME as its financial reporting framework, so in other words it would want to prepare financial statements, in accordance with IFRSs, that decision would have to be approved by the board of directors by means of a board resolution. So small and medium companies are suppose and highly encouraged to make use of GAPSME.

GAPSME is effective for accounting period beginning or after 1/1/2016. So, the companies should be making use from 2016 onwards GAPSME, to prepare their financial statements meaning to recognise assets and liabilities expenses and revenue in accordance with GAPSME.

GAPSME differentiates small companies and medium companies. How do we define a small company and a medium company?

- Small company - It is a company that has not exceeded at least 2 of the following criteria for 2 consecutive years.
    - Total Revenue should not exceed 8 million
    - Balance total not exceeding 4 million
    - Average number of employees: 50

  So if a company have a total revenue of 4Million, balance total of 6 million, and average number of employees is 10, it is considered to be a small company, because it has not exceeded at least 2 criteria.

- Medium sized company - A company that has not exceeded at least 2 of the following criteria for 2 consecutive years.
    - Total revenue not exceeds 40 million.
    - Balance sheet total 30 million
    - Total number of employees 250

Within the slides in the VLE we can find that there exist under European regulation another company which is the micro entity. There are thresholds for a micro entity; however, Malta did not adopt the concept of a micro entity. Therefore, micro entities

do not apply for Malta. What applies for Malta are the small and medium, and therefore we need TO KNOW THE THRESHOLDS ABOUT SMALL AND MEDIUM COMPANIES.

There are number of companies that are not allowed to apply GAPSME as their financial reporting framework. These are:

- Companies which do not fall under the definition of a small or medium company. I.e. being large companies.
- Pie (Public interest entities) – these cannot make use of GAPSME.

What are public interest companies?

They are defined by law as listed companies, insurance companies and credit institutions. So, these even though they might fall within the criteria for small and medium, they cannot prepare their financial statements according to GAPSME. They need to prepare their financial statements in accordance with IFRS issued by the IASB and endorsed by the EU.

EXAM - Why do PIES (PIE – public interest entity) cannot make use of GAPSME?

This is because people have trusted their money with them. So these companies cannot play with their money. They cannot throw away the money that people trusted within items. So because GAPSME is considered to be an inferior framework compared to IFRSs, these types of companies, because there is people's trust, those who have their money given to them, these companies need to have financial statement in accordance with IFRSs. This is because GAPSME has less disclosure than a normal IFRS. So because there are less disclosures these companies have to adopt IFRSs to the full. This is mainly because to public trust.

A listed company whether it has bonds, equity or it is a collective investment scheme (CIS), these type of companies, private citizens would have invested their hard-earned cash in their companies. Therefore they need to give them as much information as needed and the most comprehensive financial framework that can provide an exhaustive picture of information isn't GAPSME, but IFRS. IFRS are very detailed and have a lot of disclosure requirements they have a lot of onerous recognition and measurement principles of assets and liabilities and considered to be a very good financial reporting framework.

The same applies with banks, as you deposit money in banks and you are trusting banks. The least they can give you is financial info and comprehensive as possible. In order for you to assess the liquidity and solvency of the bank.

Insurance companies also have an element of trust. You buy a car, you cannot drive without an insurance on the roads, so you need an insurance policy in case you damage 3rd party property or else you damage you own car. I am paying a fee to the insurance company so that if something happens to my car the insurance company will pay the claim, will pay the amount of the damages. So I am trusting and paying the insurance company an amount of money. When I am paying the insurance company the risk of damaging property no longer lies with me now, but lies with the insurance company. If something happens I am not going to pay, the insurance company is going to pay. So people who buy insurance are trusting their money with the insurance company so that when a rainy day comes by, the insurance company will pay the money. So I am trusting my insurance company to pay when I incur the damage. If an insurance company goes bankrupt, I would have paid the premium, but the insurance company would not pay me the damages, so the least I can receive from an insurance company is financial information that is complete enough for me to assess the liquidity and solvency

Difference between GAPSME and IFRS

- No difference between standard regarding IAS 2
- There is no difference regarding IAS 8. The only difference regarding IAS 8 is that if there will be change in accounting policy, or a discovery of prior period error, GAPSME doesn't require a 3rd balance sheet. Example: The earliest period presented between 2017, 2016 is 1st January 2016 which means 31st December 2015. GAPSME says that there is no need for the 3rd balance
- There is no difference in IAS10
- There is no difference in IAS7
- There is difference regarding IAS41. Although Malta has a lot of fields, GAPSME is silent about the accounting for agriculture activities. So, if it is silent, the company would have to develop its own accounting policies in relation to agriculture management.
- The section in GAPSME relating to intangibles, only allows the cost model to measure intangibles. Under IAS38, there are 2 models to measure intangibles; the cost and revaluation. Under GAPSME only the cost model is allowed. Companies

under GAPSME cannot measure intangibles using fair value. As fair value isn't allowed under GAPSME there is not definition for an active market in the intangibles. Moreover under IAS 38 there are 2 types of intangibles, being those having indefinite useful life and definite useful life. GAPSME only allows intangible asset with finite useful life. Therefore you cannot classify an intangible asset under GAPSME as having an indefinite useful life. All intangibles under GAPSME will have to be amortised. On the other hand according to IAS 38 they aren't amortised but tested for impairment on an annual basis.

- IAS 1 - It is important to remember that IAS 1 requires the presentation of a comprehensive income, stat of financial position, statement of changes in equity, statement of cash flows, accounting and explanatory notes. Small companies aren't required to present a statement of changes in equity and a statement of cash flows. (medium companies need to). Small and medium companies don't need to prepare a comprehensive income statements. GAPSME never mentions statement of comprehensive income. It only mentions income statement. The statement of financial position is referred to as Balance Sheet. Notes (disclosure requirements) for SME are far less than the ones required in IFRS. There is a slide in GAPSME notes that indicates which notes should be there for small companies and medium companies.